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INTERNATIONAL MONETARY FUND

Minutes of Executive Board Meeting 97/122

10:00 a.m., December 16, 1997

Contents

Executive Board Attendance

S. Fischer, Acting Chairman
S. Sugisaki, Deputy Managing Director

Executive Directors	Alternate Executive Directors
A.A. Al-Tuwaijri	M.F. Melhem, Temporary
	R. Fernandez
	C.X. O'Loghlin
R.F. Cippa	R.J. Singh, Temporary
B. Esdar	W.-D. Donecker
	N. Coumbis
	A. Giustiniani, Temporary
	J.P. de Morais
	J. Mafararikwa, Temporary
	H. Mori, Temporary
W. Kiekens	J. Prader
	J. Jonáš, Temporary
K. Lissakers	B.S. Newman
A. Mirakhor	M.A. Ahmed, Temporary
	L. Palei, Temporary
	J. Shields
A.S. Shaalan	
M.R. Sivaraman	H.B. Disanayaka
E. Srejber	
G.F. Taylor	C.M. Gonzalez, Temporary
J.J. Toribio	J. Guzmán-Calafell
J. de Beaufort Wijnholds	Y.G. Yakusha
K. Yao	A. Barro Chambrier
Y. Yoshimura	H. Ono
Zamani, A.G.	O. Sein, Temporary
Zhang Z.	Han M.
A.G. Zoccali	N. Eyzaguirre

R.H. Munzberg, Secretary
S.W. Tenney, Assistant

World Economic Outlook—Interim Assessment—Implications of the Financial Crisis in Southeast and East Asia
Staff representatives: Mussa, RES; Larsen, RES; Hacche, RES

Also Present
WTO: C. Boonekamp. African Department: P. Dhonte, Deputy Director. Asia and Pacific Department: T.A. Bayoumi. European I Department: M.C. Deppler, Director; E.V. Clifton. External Relations Department: S.J. Anjaria, Director; M.E. Hansen. Fiscal Affairs Department: P.S. Heller, Deputy Director; D.F. Gray, S.A. Symansky. Legal Department: W.E. Holder, Deputy General Counsel. Middle Eastern Department: V. Sundararajan, Deputy Director. Policy Development and Review Department: J.T. Boorman, Director; R.H. Nord. Research Department: M. Mussa, Economic Counsellor and Director; F. Larsen, Deputy Director; J. Aziz, F. Caramazza, M. De Broeck, P.R. De Masi, J.A. Gable, S.J.A. Gorne, G. Hacche, P.R. Masson, G.M. Meredith, R.M. Salgado, A.J. Tweedie. Secretary's Department: P. Gotur, A. Mountford. Statistics Department: C.C. Carson, Director. Treasurer's Department: D. Williams, Treasurer; M.G.Kuhn, M.A. Wattleworth. Western Hemisphere Department: C.M. Loser, Director; S.V. Dunaway. Office the Managing Director: M. Russo, Special Advisor; J.A.P. Clément, O.J. Evans. Advisors to Executive Directors: W.F. Abdelati, T. Brizuela, J.A. Costa, S.S. Farid, P.M. Fremann, R.J. Heinbuecher, H. Kaufmann, A. Levy, J.-C. Obame, E. Rodriguez. Assistants to Executive Directors: N.R.F. Blancher, J.G. Borpujari, P.I. Botoucharov, H.W. Cocker, D.A.A. Daco, C.K. Duenwald, D. Fujii, M. Kell, Lai K., J.P. Leijdekker, Lu A., S.D. Melese-d'Hospital, F. Mercusa, A.R. Palmason, S. Rouai, J. Salleh, R.P. Watal, Zubir bin Abdullah.

1. WORLD ECONOMIC OUTLOOK—INTERIM ASSESSMENT—IMPLICATIONS OF THE FINANCIAL CRISIS IN SOUTHEAST AND EAST ASIA

The Executive Directors, meeting in restricted session, considered a staff paper on an interim assessment of the world economic outlook—regional and global implications of the financial crisis in Southeast and East Asia (EBS/97/231, 12/9/97). They also had before them a background paper on world economic and market developments (EBD/97/133, 12/12/97), a background paper on exit strategies—policy options for countries seeking greater exchange rate flexibility (SM/97/285, 12/12/97), and a report on foreign exchange and financial markets in November 1997 (EBD/97/134, 12/12/97).

The Economic Counsellor and Director of the Research Department made the following statement:

> I will review recent developments in the industrial countries before turning to the emerging market economies and the ongoing crisis in East Asia.
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> Since the previous discussion in early November (IS/97/6), bond yields have declined in most major industrial countries, as the deepening crisis in Asia prompted a widespread flight to safety, reduced concerns about inflation, and lowered growth expectations. Following the sharp sell-off in late October, equity markets in the major industrial countries had rebounded, in some cases to near previous peaks, before the deteriorating situation in Korea prompted a further downward correction last week. In Japan, the stock market fell to a new 28-month low in mid-November before a modest recovery on expectations of government measures to address weaknesses in the financial system.
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> In exchange markets, the yen has fallen sharply in reaction to the deteriorating domestic outlook and concerns about spillovers from the deepening crisis elsewhere in the region. The U.S. dollar has been the main beneficiary of the turmoil in Asia, rising by 9 percent against the yen since the previous discussion, and more modestly against major European currencies. The Australian and New Zealand dollars have also fallen sharply against the U.S. dollar, reflecting their strong trade and investment links to Asia.
>
> The turmoil in Asia has also contributed to recent declines in commodity markets. Since midyear, the Fund's index of nonfuel primary commodity prices has fallen 9 percent to near its average level in the early 1990s, mainly a result of price declines for a number of commodities where Asian countries are important consumers or producers. Gold prices also continued their recent slide, falling to well below $300 an ounce amid news of further central bank sales, and oil prices have dropped by about 15 percent since October, in part reflecting an easing of tensions in the Middle East and the increase in OPEC output quotas. These factors suggest a subdued inflation environment in the world economy in the period immediately ahead.
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> Aside from Japan, the major industrial countries seem well positioned to absorb the adverse shock coming from Asia. In the United States, third-

quarter GDP growth was revised down slightly to 3.3 percent, mainly reflecting lower inventories, but consumer spending and business investment remained strong, and incoming data for the fourth quarter point to further robust growth in output and household spending. Consumer confidence remains at, or near, all-time highs, and over 400,000 new jobs were added in November. Hours worked increased, and the unemployment rate fell to 4.6 percent, a new 24-year low. Falling long-term interest rates are also helping to sustain demand in interest-sensitive areas, such as housing.

Direct measures of prices indicate that inflationary pressures are receding, rather than advancing, and the strong dollar and weak import and commodity prices suggest that this trend will continue for at least a while longer. Buoyant investment in new capacity has helped contain cost pressures, with rapid productivity growth in the third quarter slightly out pacing the rise in labor earnings. However, the labor market situation looks increasingly less benign unless there is soon some slowing of employment growth. Average hourly earnings growth has almost reached the peak of wage inflation in 1989, and the rate of growth in employment costs has also turned up, particularly in the services sector. Also, the moderation of medical benefit costs, which has helped hold down overall labor costs in the current cycle, could be coming to an end.

The Federal Reserve must now balance domestic considerations, which would ordinarily point to higher interest rates to dampen domestic demand, with the expectation of a slowing due to external developments and with the broader global concern that a tightening now could further destabilize international financial markets and compound the disruption of capital flows to emerging market economies. In testimony before the House Banking Committee in mid-November, the Chairman of the Federal Reserve Board cited the Asian financial crisis as one of the factors behind the FOMC's decision to leave rates unchanged at its meeting on November 12, 1997, and financial markets anticipate a similar decision at today's meeting.

Domestic demand has become the main driving force behind the recovery in Canada, where real GDP grew at an annual rate of 4.1 percent in the third quarter, the current account deficit widened to 3 percent of GDP, from near balance at the beginning of the year, and capacity utilization has risen to near previous highs. Also, the unemployment rate fell back to 9 percent in November—a full percentage point lower than a year earlier. The Canadian currency recently weakened to near 12-year lows against the U.S. dollar on concerns about the effects of the Asian crisis on commodity prices and the demand for Canadian exports. In response to continued signs of robust growth and recent currency weakness, the Bank of Canada recently raised official interest rates by a further 50 basis points, following a 25 basis point increase in late November.

In Germany real GDP grew at an annual rate of 3.2 percent in the third quarter, compared with 4.1 percent in the second quarter. As private consumption fell back after the strong second quarter and construction is still weak, exports remained the main driving force behind the recovery. The unemployment rate held steady at a postwar high of 11.8 percent. Inflation concerns have eased as the price effects of the deutsche mark's earlier weakness have begun to fade, and broad money growth has continued to decelerate. With no imminent inflation threat and continued uncertainty about the strength of the recovery in domestic demand, the Bundesbank appropriately has put further monetary tightening on hold for the time being.

In France, output expanded at a 3.5 percent annual rate in the third quarter, with domestic demand growing at 5 percent, and recent data point to further improvements in business sentiment and a pickup in consumption and construction activity. However, the recovery has yet to cut into unemployment, with the rate holding steady at about 12.5 percent for more than a year. Inflation remains low at slightly over 1 percent.

In Italy, output growth moderated to an annual rate of 2.9 percent in the third quarter, following the spurt in the spring, suggesting that growth for 1997 as a whole may come in close to 1.5 percent. The inflation rate held steady at 1.6 percent in November. In anticipation of a further official interest rate cut, short-term market rates have fallen by more than 50 basis points since early November, after the political crisis associated with proposed reforms in the 1998 budget was resolved. Market expectations are for further convergence of short-term interest rates to those in Germany over the next year. Bond yield spreads over German rates have fallen below 40 basis points.

In the United Kingdom, the Bank of England's Monetary Policy Committee left official rates unchanged at its meeting on December 4, 1997. Recent data provide mixed signals on whether domestic demand growth is moderating enough to achieve the government's inflation target. Broad money and consumer credit growth remain strong, and inflation has been steady at 2.8 percent in recent months, somewhat above the target. At the same time, industrial output has been sluggish, and average earnings growth has not accelerated, despite a tight labor market. While the economy still appears to have significant forward momentum, the decision to pause is justified given the significant monetary tightening already in place and taking account of the pound sterling's continued overall strength and the ongoing fiscal consolidation.

Elsewhere in Europe, domestic demand growth is quite strong and labor market conditions have tightened in a number of countries, including the Netherlands, Norway, and to a lesser extent, Sweden, where the central bank raised the repo rate by 25 basis points last week in the first tightening move since rates were lowered by almost 500 basis points in 1995/96. In Portugal and Spain, convergence has continued, as official interest rates have been cut by a further 20–30 basis points since the previous discussion on world economic and developments. Exports remain the main driving force behind the recovery in Switzerland, where real GDP grew at an annual rate of 1.7 percent in the third quarter.

In Australia, output growth jumped to 6 percent in the third quarter and employment growth strengthened in November, as domestic demand continued to be buoyed by previous monetary easing. However, the external position is showing the effects of slower growth in Asia, as the previous narrowing trend in the current account deficit was reversed in the third quarter and the trade balance moved back into the red in October. Activity is weaker and the current account deficit has widened sharply in New Zealand, where the central bank endorsed a further monetary easing yesterday.

In Japan, there has been little positive news since the previous discussion. Concerns about the health of the financial sector reached critical proportions in late November following the failure of several financial institutions, including the fourth largest brokerage firm and a major city bank, within a month. Banking stocks fell further, and the premia paid by Japanese banks on loans in the Euromarket rose in early December to double their previous peaks in 1995, before falling back somewhat as the central bank injected large volumes of liquidity. While problems in the financial sector were not news, the latest failures, combined with the uncovering of large hidden losses in one case, focused attention on the size of the problem and on the inadequacy of measures taken so far to address it. The expected announcement of a new package of economic and financial measures has been postponed until tomorrow. Press reports suggest the package will include modest tax cuts and the issuance of special bonds to boost the capital of the Deposit Insurance Corporation.

As the staff recently reported, the third quarter rebound in activity in Japan was weaker than expected, leaving output at about the same level as in the final quarter of last year. The sluggishness appears to have carried over to the fourth quarter as household spending and industrial production declined in October, new car sales fell back sharply in November, and labor market conditions have weakened again after signs of improvement earlier in the year. The external sector's contribution to third quarter growth was negative, but the trade surplus widened sharply in October, as exports rebounded while import growth slowed. The December quarter Tankan survey, released yesterday, showed a sharp deterioration in business sentiment across the board, including among the major manufacturers who previously had been faring somewhat better, and expectations for a further deterioration in the coming quarter. With this information, the forecast in the World Economic Outlook, which is based on the assumption of 2 percent growth in Japan in 1998 on a fourth-quarter-to-fourth-quarter basis would appear subject, on balance, to considerable downside risks.

Turning to developing and transition countries, as discussed in the staff paper on the world economic outlook exercise, the deepening crisis in Asia has had strong spillovers on emerging market economies.

In the first half of November, the Brazilian real came under speculative attack, reflecting renewed doubts about the sustainability of the existing exchange rate policy in light of the large fiscal deficit and weakening external position. There were spillovers on Argentina, where interest rates rose sharply and the spread between rates on peso and U.S. dollar-denominated deposits widened by about 450 basis points, and on Mexico, where the interest rate rise was more moderate and the peso weakened by about 7 percent against the dollar. As the staff recently reported, the pressures eased after the Brazilian authorities raised interest rates sharply and introduced a strong fiscal package, supported by progress on structural reforms. Market sentiment may also have been helped by news that Argentina had reached preliminary agreement with the Fund on a new three-year economic program, and the Mexican government released its draft 1998 budget, which broadly maintains the current fiscal stance. Chile was less affected by the recent financial market turmoil, but the peso weakened against the dollar on concerns about the effect of slower growth in Asia on Chilean exports. Latin American markets recovered somewhat in the second half of November and, until last week, had been relatively unaffected by the deepening crisis in Korea. Bond yield spreads have narrowed from their mid-November peaks, although they remain well above the lows reached prior to the mid-October sell-off.

In Africa, domestic factors sparked a currency crisis and a steep fall in the stock market in Zimbabwe, where the external position has deteriorated sharply against the background of an unsustainable fiscal position, and a planned land transfer scheme has further weakened market sentiment. In South Africa, markets have not been significantly affected by the turmoil elsewhere, although the fall in world gold prices has put downward pressure on the stock market and the exchange rate.

In India the rupee weakened by about 7 percent in November and equity prices continued to slide amid a growing political crisis that led to the collapse of the coalition government. The currency stabilized somewhat after the authorities raised short-term interest rates and the bank cash ratio requirement, and tightened exchange controls. Recent political instability also raised some new concerns about the economic situation in Pakistan. In China, strong exports continue to underpin output growth, which slowed modestly in the summer. So far, negative effects are not apparent on the Chinese economy from developments elsewhere in Asia, but some such effects are surely coming, perhaps along with a slowing of the real estate boom in some cities. Earlier this month the authorities announced plans for a further interest rate cut aimed at boosting domestic demand.

The spillover effects from the Asian crisis on several transition countries were discussed extensively at the recent informal session on country matters; since that time there has been renewed weakness in some cases.

As Directors are aware, among the East Asian countries most affected by the crisis, the situation remains extremely fragile. The Korean won rebounded by a further 9 percent today after the government eliminated the daily trading band for the won and raised the interest rate ceiling to 40 percent. Elsewhere, however, exchange rates in Thailand and Indonesia fell to new lows before rebounding on central bank intervention. The Malaysian ringgit has remained under downward pressure, and the Philippine peso has weakened sharply in recent days, notwithstanding the recent passage through Congress of the long-awaited tax reform bill. Pressures on Hong Kong SAR, Singapore, and Taiwan Province of China had eased prior to the renewed turbulence last week, and these economies remain significantly less affected than the ASEAN-4 and Korea.

Turning to the global economic implications of the crisis, it is useful to focus on developments in international capital markets. In late October as the crisis in South East Asia went global, we saw sharp upward spikes in yield spreads for most emerging markets. Usually such sharp price movements foretell sharp changes in capital flows. Data for the spring and summer show that gross flows of private capital to emerging markets were running at an annual rate of over $380 billion, more than one-and-a-half times the record set in 1996. Preliminary data for November provide a clear indication of the extent to which capital flows to the emerging market economies were disrupted as the crisis deepened and spread beyond Southeast Asia. New bond issues fell to practically zero during the month, down from $9 billion in October and an average of $15 billion per month in the previous two quarters. Total gross capital flows dropped to $13.5 billion, compared with $28 billion in October and over $30 billion per month in the previous two quarters. Gross flows to Asia totaled $4 billion in November, compared with a monthly average of over $14 billion in the second and third quarters, while flows to Latin America fell even more sharply to $1.7 billion in November.

This sharp fall-off in gross new capital flows to emerging markets partly reflects decisions to postpone issues, rather than a collapse of demand. And, with respect to the more important question of net capital flows, the drop in gross flows will likely be cushioned by reserve use or less reserve accumulation. Nevertheless, it is clear that after rising to a new record pace in the first half of this year, from the record already set last year, net capital flows to emerging markets will decline sharply in the later part of 1997 and be down for the year as a whole, especially for Asia. This is revealed both in estimates for the dollar value of capital flows to emerging markets and, more important, in the estimated ratios of capital flows to emerging market GDPs.

For the near term, the drop in the annual rate of capital flows from mid-1997 to the end of 1997 and the first part of 1998 could well be on the order of $100 billion. This drop in net flows will be partly and temporarily absorbed by reserves, but will also necessarily imply a significant downward adjustment in the current account deficits of emerging market countries, and a corresponding opposite adjustment in the current accounts of the industrial countries. While Japan will feel a substantial impact from the current account adjustments of other Asian economies, the weakness of demand within the Japanese economy and the weakening of the yen against other industrial country currencies suggest that the Japanese current account position will show little net change and perhaps even a small improvement. Thus, the current account adjustment of the emerging market countries will have to be absorbed primarily by the industrial countries of North America and Western Europe.

The world economic outlook forecasts allow for such an adjustment, amounting to about $50 billion for current accounts, with a somewhat larger figure implied for real net exports. The impact effect, allowing for a modest multiplier, should amount to about one half of 1 percent of GDP for North

America and Western Europe combined, probably with a somewhat larger proportional effect on North America. Because these industrial economies appear stronger now than they did in September, the revision to the world economic outlook forecasts is quite modest. In this sense, the emerging markets crisis could hardly have happened at a better time. If the crisis proves to be deeper and more prolonged than envisioned in the interim World Economic Outlook, easier monetary policy in North America and Europe could help maintain world output growth; but the risks to the downside in Asia and more generally remain substantial.

Taking a longer-term perspective, relative to their GDPs, net capital flows to developing countries—excluding the transition and the Middle East economies—have substantially exceeded the levels reached in 1975–82. Except for the drop-off in 1995, net flows to Latin America have averaged about 4 percent of aggregate GDP since 1992, similar to the level prevailing prior to the 1982 debt crisis. Net flows to Asia reached a similar level recently prior to the fall now projected to affect 1997 toward year-end and the even larger decline reasonably expected for 1998 as a whole.

Can we reasonably expect a swift rebound in capital flows next year, as we saw in the wake of the tequila crisis, or are we more likely to see a sustained drop-off lasting several years, such as that which followed the 1982 debt crisis? No one can reasonably be certain.

Clearly, the action will primarily be in Asia, and Japan is a key issue. Its economy is four times the size of the ASEAN-4 and Korea combined. The problems in the Japanese financial sector, which continue to undermine confidence and threaten renewed recession—or worse—are substantial, but are of manageable proportions with an adequate commitment of public resources. Further denial and delay in honestly facing up to these problems and to their costly solution is no longer credible, whatever the political consequences. While much of the rest of the world outside Asia must reasonably accept a weaker yen and a probable widening of trade imbalances vis-à-vis Japan, it may also reasonably expect Japan to act forcefully in its own interests, and in the broader interests of the world community, to correct the problems in its financial sector and to lay the basis for sustained recovery of the Japanese economy based primarily on its own demand.

Beyond Japan, the greatest need for convincing action—in their own interests, in the region's interests, and in the global interests—is with the east Asian economies most affected by the present crisis. This does not deny the essential role of adequate international support; but to be effective, international support must be for actions clearly worthy of such support.

The situation has deteriorated further than could have been anticipated a couple of months ago. While the reasons for this are many, one key element has been the self-reinforcing nature of the crisis, whereby the reluctance of policymakers to address problem areas in advance of the crisis and failure to move with sufficient force and determination once the crisis hit, has tended to undermine confidence throughout the region. Excessive exchange rate depreciations, beyond any reasonable judgment of what was initially needed to improve competitiveness, have been an important element of this phenomenon. In this regard, the reluctance to tighten monetary policies with sufficient determination and persistence to underpin exchange rates has clearly been an aggravating factor.

Granted that tighter monetary policies do not have short-term salutary effects on weak economies with sick financial systems, experience suggests that when a crisis of confidence threatens or is under way, an effort to keep monetary policy relatively easy is often counterproductive at home and damaging abroad. For economies with substantial foreign currency debts, steep depreciation undermines the solvency of domestic firms and financial institutions as much or more than moderate increases in interest rates. And, as confidence further erodes, the increase in interest rates ultimately necessary to stabilize the situation escalates.

This is a key lesson from experience in the "tequila" crisis and from more recent experiences in Brazil, Hong Kong SAR, the Czech Republic, and the Russian Federation. A period of sufficiently tight money is essential both to defend a currency peg and to restore stability in the exchange rate once confidence in the currency has been lost. The question of how tight is difficult to answer. In Mexico, after the authorities lost control of the situation in late 1994 and early 1995, and confidence had been eroded by an initial period of inadequate policies, nominal interest rates on 28-day cetes had to rise to 70–80 percent for a couple of months to stabilize the exchange rate. Mexico's history of instability and high inflation probably meant that interest rates had to go further than might otherwise have been the case. However, the key element in the end was that the authorities showed the determination to do what was needed to stabilize the exchange rate.

Argentina held to its exchange rate peg in the tequila crisis and, accordingly, avoided the collapse of confidence that would have accompanied its abandonment in view of Argentina's history of rapid inflation prior to 1990. This success, however, had unavoidable short-term costs in terms of high interest rates that cut deeply into domestic demand and helped to bring needed improvement to the current account.

Both Mexico and Argentina faced major banking crises in early 1995. In both cases, the sharp monetary tightening was accompanied by early, albeit imperfect, actions to address the weaknesses in the banking sector, including liquidity support, recapitalization and, particularly in Argentina, the exit of insolvent institutions from the system. And through these actions, it was possible to survive a period of tight monetary policy without precipitating a collapse of the financial system.

In both Mexico and Argentina, firmer monetary policies and actions to deal with the financial sector were not the whole story. Notwithstanding the generally sound stances of fiscal policies prior to the crisis, moderate degrees of fiscal tightening were also appropriate and useful to help reduce current account deficits, to support confidence, and to make fiscal room for the public sector costs of financial sector restructuring.

The recent experience of Brazil provides another good example. When the external environment for financing Brazil's substantial current account deficit turned sharply less accommodating in October, the central bank moved forcefully to double already high interest rates. This, however, was not enough to relieve pressures on the *real* because markets judged, correctly, that weakness in the public finances, not lax monetary policy, was a fundamental problem. When the authorities moved to address this core problem, exchange market pressures eased further, despite continuing turbulence in Asia. The short-term cost of all of this, of course, will be a sharp slowdown of domestic demand in Brazil, which is needed to improve the current account. Until significant improvement becomes apparent, the situation will remain fragile and sensitive to adverse external developments.

For the East Asian economies, the fiscal situation was generally not problematic before the present crisis; but moderate fiscal adjustments are appropriate to contribute to the current account adjustments needed in varying degrees in different countries, to bolster confidence, and to amortize the fiscal cost of financial sector reform. Firmer monetary policies as also required to avert excessively large exchange rate depreciations. Judged by the extent of depreciations against the dollar and on a real effective basis, performance has not been very satisfactory. For Indonesia, Korea, and Thailand, the depreciations have been essentially on the same scale as Mexico's depreciation in 1994–95. In contrast, Brazil with its policy measures has been able to maintain its exchange rate policy. The difference is at least partly explained by how monetary policy has been handled. As previously noted, when exchange market pressures developed, Brazil raised its already high real interest rates, and has subsequently kept rates quite high. Indonesia raised rates strongly at the outset of the crisis, but then backed off; and Indonesia's inflation rate is higher than Brazil's, implying less of a sustained increase in real interest rates. Korea, Malaysia, and Thailand show comparatively little interest rate response to their exchange market crises. The Philippines has a somewhat larger and more sustained response; and it has also suffered somewhat less exchange rate depreciation.

The short-term effect of the needed policy adjustments in East Asian economies would normally be to slow the growth of domestic demand and, to a lesser extent, of output, as current account deficits are brought into line with reduced external financing flows. Unfortunately, now that the crisis has gotten out of hand, the extent of the economic slowdown will likely be much greater than would otherwise be needed. This result is not the intended effect of recommended policy measures; it is the consequence of a collapse of confidence that reflects inadequate policy responses at an earlier stage, as well as unreasoned panic in financial markets.

How deep will the crisis go, and how rapidly might a recovery begin? As indicated at the previous discussion on world economic and market developments, provided proper policies are implemented, a Vee-shaped pattern of recovery can be expected in the Asian countries most affected by the present crisis—as was the case in Mexico and Argentina in the tequila crisis. For about a year, output growth will slow very sharply or turn negative in some cases; and then toward the end of next year fairly vigorous recoveries will begin. This pattern will be even more pronounced in domestic demand, especially in investment, than in GDP. Capital flows to these countries will likely follow this same vee-shaped pattern, but they will respond to, rather than drive, progress on the upside.

It should be emphasized that a vee-shaped pattern has a downleg, followed by an upleg. In the revised world economic outlook forecasts, we are still underestimating the downleg, while financial markets fail to appreciate the potential for the upleg. For all of East Asia, including Japan and China, the staff's forecast for growth in 1998 is still too high by about 1 percentage point, spread unevenly across the region. For the world economy, I would suggest a downward revision of the October *World Economic Outlook* forecast by 1 percentage point, rather than by 8/10 of 1 percentage point. As a round number, this revision conveys the right impression that, in view of the evolution of the crisis in recent weeks, world growth is likely to be slower by about 1 percentage point—but not by 2 percentage points—than was previously expected.

Mr. Kiekens and Mr. Jonáš submitted the following statement:

We would like to thank the staff for preparing, on such short notice, this very concise analysis of the financial crisis in Asia. At this stage, amid many remaining uncertainties about the future course of the crisis, we can provide only tentative answers to many questions, the most important being how to minimize the damage done by the crisis to the world economy.

We find the staff's discussion of the factors contributing to the crisis very much to the point. We would only underline that the crisis was not caused by any single factor, but by the particular way in which several factors interacted. Rapid economic growth in Southeast Asia attracted strong investor interest and investments, but initial successes also contributed to less prudent behavior, perhaps in the expectation that the good times would last indefinitely. The less prudent behavior, in turn, resulted in a gradual buildup of weaknesses and misallocation, because in many countries, traditional but sometimes inefficient ways of allocation persisted. Unfortunately, as long as strong growth and capital inflows continued, the accumulation of misallocation was not obvious. And even though some trends in the region clearly became unsustainable, it was not always clear, especially to the authorities, that a strong policy adjustment was needed to get these countries back onto a path of sustainable current account deficits, and sustainable growth of external indebtedness.

The large inflow of foreign investment toward Southeast Asia resulted from overestimation of the benefits and underestimation of the risks and costs of financing. The strategy of investment was changing, with investors becoming more willing to take more risks and large institutional investors trying to diversify their portfolios. The result was a significant increase in the supply of funds to emerging market countries, in particular, after the Mexican crisis, to Southeast Asia. The compression of spreads observed since 1995 partly reflects the increased supply of financing to emerging market countries. The attachment, sometimes perhaps too strong, to fixed exchange rates has reduced the perception of exchange rate risk by both lenders and borrowers to a dangerously low level.

However, it would not be accurate to argue that the high flow of foreign investment to Southeast Asia resulted solely from investors' imprudence. It should be noted that the major rating agencies failed to warn investors about the risks they might be facing. In some cases, even this Board failed to foresee the problems that lay ahead. For example, during the Board discussion in November 1996 of the report of the Article IV consultation with South Korea, the Board "welcomed Korea's continued impressive macroeconomic performance . . . Welcomed Korea's prospective membership in the OECD . . . and noted the challenge of ensuring that the speed of structural reforms in the financial sector . . . was commensurate with the needs of Korea's transformation into a industrial economy." And the Bank for International Settlements (BIS) report for 1996–97 shows that in Korea, nonperforming loans in 1996 were less than one percent of total loans. There is hardly any basis in this information for predicting a crisis.

However, it is also true that before the crisis started, the Board more than once expressed concern about ample liquidity in the markets, and about the sizable compression of spreads that seemed to go beyond what would be justified by the riskiness of loans to emerging markets. Perhaps the crisis will serve a useful purpose in the future if it reminds market participants about the risks of their investments.

We agree that the crisis will result in a marked reduction of private capital flows to emerging market countries, and that the price of this financing will rise to better reflect the risk premium, which itself will probably be affected by the recent crisis. While there is not much that can be done to reverse the slowdown of capital inflows in the short run, governments' response to the crisis will have important implications for the size and conditions of capital inflows further down the road, and will therefore affect the size of the adjustment that these countries will have to undertake in the longer term. Also, we can expect that the supply factors that contributed to large inflows of capital to emerging market countries in the past will still be in place, as investors continue to seek the benefits of diversification. While present crisis will certainly make them more mindful of the risks of these investments, we think that the far-reaching structural reforms stimulated by the crisis could ultimately make the emerging market countries attractive again.

The reduced availability of private financing, and the limited ability of official financing to offset the outflow of private funds, make it necessary for the emerging market countries to adjust their external positions. We agree with the staff that the corresponding adjustment in the external positions of the developed countries will only reduce, rather than halt, the ongoing expansion.

However, we would like to know how the crisis has affected the staff's assumptions about long-term interest rates. Does the staff expect that the reduced demand for bonds in the emerging market countries will result in a higher demand for bonds in the advanced economies, resulting in higher prices and lower yields? Perhaps the recent fall in long-term interest rates in the United States shows that such a shift is already taking place. And could this effect be strong enough to offset the negative effect of the trade channel on economic growth in the advanced economies?

The crisis in Southeast Asia has implications for the optimal policy stance in the advanced economies. We agree with the staff that at this point, there is little reason to increase U.S. interest rates. Also, we think that the recent small increase in interest rates in Europe is sufficient at this point. All the advanced economies should keep their monetary policy options open until it is possible to make a better assessment of the effects of the crisis on the world economy.

For Japan, the slowing of economic activity and the weakness in the financial sector is cause for serious concern. After all, Japan's economy is nearly twice the size of the nine other Southeast Asian economies combined, including China. We agree that given the renewed weakness of domestic demand, it is probably unwise to continue withdrawing the fiscal stimulus. However, with public debt approaching 100 percent of GDP, the suspension of fiscal consolidation cannot last very long, and a temporary change in the fiscal stance does not affect domestic demand as strongly as one would like to see. We believe that the decisive solution of the problems of the financial sector, including closing weak institutions and strengthening those that can survive, would be the best way of restoring consumer and business confidence and strengthening economic growth.

As to countries' policy responses for defending the exchange rate and containing the crisis, we find their policy response generally adequate. The failure of the policies pursued to calm the financial markets up to now has more to do with the way these policies were implemented than with their content. On several occasions, country authorities were hesitant to take difficult measures, and when they eventually did implement them, the markets were not fully convinced about their support for the policies. For example, in South Korea, and also till recently in Malaysia, the authorities were not ready to let interest rates rise far enough to stabilize the markets.

We have noted the criticism that tight fiscal and monetary policies are not the right prescription in the present situation, but we believe this criticism is only partly valid. It can be argued that the countries in Southeast Asia were pursuing appropriate fiscal policies, that fiscal balances do not figure among the prominent concerns of market participants, and that there is only a limited need to tighten fiscal policies further. The extent of the fiscal tightening should reflect the expected future costs of financial support for ailing banks, so that the use of public money for this purpose does not weaken the fiscal position enough to become a cause for concern. But we are strongly persuaded that tight monetary policy must be a part of the policy response to the crisis, and that without sufficiently high interest rates, confidence will not be renewed. We recognize that high interest rates can be very painful, especially in economies with highly leveraged corporations, but we think the evidence from countries that hesitated to raise interest rates shows clearly that low interest rates will not stabilize markets. More fundamentally, we think the permanent withdrawal of foreign capital as a result of insufficiently high interest rates will damage the economy more severely than temporarily higher interest rates would do.

Moreover, interest rates play an important role as a signal of the authorities' determination to tackle the existing problems, because ideally they should be the first line of defense against a crisis, and can be clearly seen and understood by market participants. Failure by the authorities to use this instrument in a determined way is a signal to the market that the authorities may equally hesitate to take other measures that are more difficult to assess, particularly in the area of structural reform.

This does not mean that the authorities are completely at the mercy of the markets regarding interest rates. How much and for how long interest rates must rise to stabilize the markets depends very much on what impression the authorities give to the markets about their willingness to accomplish the necessary reforms, the speed with which they move, and the breadth and depth of their political and popular support. We believe these factors go further to explain the failure of the Fund's programs to stabilize the situation up to now than any alleged mistakes in the design of the programs themselves. We are now persuaded that the authorities in all the countries affected by the crisis have realized this, and if they will act accordingly, we can be cautiously optimistic in the expectation that the crisis will be contained in the region and that the situation in Southeast Asia it will gradually stabilize.

Mr. Zoccali and Mr. Eyzaguirre submitted the following statement:

We welcome the opportunity to discuss the current assessment of the world economy and the short and medium-term projections for emerging markets. At the outset, we would like to express our concern about the excessive disruptions associated with the international adjustment process. Although in the less pessimistic baseline scenario, world output and growth prospects in the industrial countries remain satisfactory, the forecasted effects of the unfolding crisis for the emerging economies are worrisome. On top of a downward revision of growth in Asia of 1.7 percentage points in relation with our last October projections, growth in Western Hemisphere countries is projected to decelerate from more than 5 percent in 1997 to just 3½ percent in 1998. Countries in transition would also suffer a 0.8 percent cut in their growth prospects. Furthermore, in the alternative scenarios where further falls in capital outflows to emerging economies of $50 billion and $100 billion—in relation to the baseline projection—are assumed, additional growth losses ranging from 2 to 4.5 percent points of emerging markets' GDPs may occur.

The latter sequence of events has to be avoided. While admittedly the main responsibility for corrective policies lies with the countries experiencing the crisis, all countries should internalize the situation and adapt their policies accordingly.

To begin with the industrial economies, notably less affected by these financial disturbances, we deem it essential that their economic policies adequately take into account their systemic importance. We fully concur with the concept expressed in the interim World Economic Outlook, that for Europe and North America it would be appropriate to put further monetary tightening on hold for now. Without downplaying the importance of a preemptive control of inflationary pressures in the U.S. as well as the legitimate desire in Europe for a steadfast implementation of the monetary union and a strong Euro, it is important to coordinate those desirable objectives with the shared goal of fostering world economy stability. The evolution of the Japanese economy in the near term is particularly critical. Although it is clear that so far the difficulties of the financial system in Japan are of a domestic character, recent experiences have dramatically shown how difficulties initially circumscribed to the domestic financial sector may spillover to the rest of the economy through an unwarranted weakening of the domestic currency if creditors and depositors, worried about the soundness of the financial system, begin to switch the composition of their portfolio holdings toward foreign currency–denominated assets. In that regard, due attention has to be paid to the widening of the premiums charged to Japanese banks in the international money markets. We agree, therefore, that there is an urgent need to ensure that insolvent banks in Japan do not jeopardize the health of solvent institutions and to reduce the risk of a continuing credit crunch. As asserted in the interim World Economic Outlook, this will require a write-off of problem loans, the restructuring and consolidation of the banking sector including the closure of insolvent institutions, and the provision of well-targeted additional public funds. In the macroeconomic sphere a suitable phasing of the corporate tax reform and the avoidance of further contractions in public investment are deemed essential.

The asymmetries of the international adjustment process are all too clear when the prospects of the emerging economies are analyzed. While the impact on the industrial countries is estimated through the external trade multipliers, on the basis of the first round impact on domestic growth of reduced exports to the affected areas, the magnitude of adjustment in emerging economies is inextricably linked also to the prospects of continued private flows; the larger the decline in international financial flows, the larger the domestic adjustment to accommodate the current account to the new conditions affecting capital movements. In this regard, the interim World Economic Outlook estimates the shift in the current account balances of developing countries, newly industrialized Asian economies and transition economies combined, to be in the range of $14 to $57 billion—admittedly a wide interval, with a somewhat confusing explanation on page 59. Moreover, the staff further asserts that this will mean a reversal of the pattern seen earlier in the decade when strong domestic demand growth and widening current account deficits in emerging economies helped sustain global growth in the context of weak demand in industrial countries. While that pattern seems to be unavoidable to some extent, one should not forget that in spite of better domestic internal demand conditions in industrial countries the situation remains somewhat unsettled and, more importantly, that the recent crisis in Asian emerging market economies was not initially of a predominantly macroeconomic origin and thus should not lead to sizable macroeconomic consequences. Macroeconomic fundamentals in most emerging economies remain solid and therefore macroeconomic adjustment should not be regarded nor allowed to be the main element of the solution to a problem that relates mainly to financial sector fragility. The generalized character that financial problems exhibited in some Asian economies explains why the flight to safety in depositors' and creditors' actions resulted in both a foreign exchange and macroeconomic crisis. Therefore, the solution must lie predominantly in a confidence-building effort. For that purpose, we should demand from the affected countries the utmost commitment in addressing their financial sector weaknesses to deter capital flights.

When stressing that current account adjustment is needed in view of the projected reversal of capital flows in some emerging economies, we may run the risk of generating a self-fulfilling prophecy. Emerging markets fundamentals are generally strong, and they should continue to generate capital inflows albeit in lower amounts. The few countries that exhibited some macroeconomic imbalances have displayed convincing corrective measures, most notably Brazil, and the continued strengthening of macro fundamentals in other emerging economies should contribute to build confidence and revert rapidly the adverse shift in market sentiment. A significant contractionary adjustment across countries, on the other hand, would be counterproductive. While further monetary tightening and moderate fiscal consolidation efforts are warranted in some cases, specially in these ones experiencing pressures in the foreign exchange market, it should not lead us to believe that current account improvements implied by the contraction of domestic demand are going, by themselves, to stabilize the markets.

When analyzing the origins of the crisis, too often excessive emphasis has been put on macroeconomic mismanagement. With the notable exception of Thailand and some episodes of premature monetary easing, we do not share the view of macroeconomic policy errors as the key explanatory variable of the crisis. Exchange rate policy differed significantly among affected countries and included a good deal of flexibility in the Korean case. While monetary policy was sometimes accommodative, it is also being asserted that tough monetary conditions in some countries encouraged short-term inflows in the early stages. In this regard, when domestic demand pressures were at their peak even a flexible exchange regime would not necessarily have prevented capital inflows. Moreover, the degree of appreciation that would be needed before depreciation expectations develop is sometimes excessive even in cases where some further fiscal consolidation efforts would have helped.

A less costly process of international adjustment could be achieved if bold action was taken where the true problem lies: in the financial sector. The tougher and more decisive the actions to restructure the financial system—including in areas of disclosure, governance related or directed lending—the sooner the desired vee-shaped recovery identified in the cases of

Mexico and Argentina will be achieved. Lack of bold and comprehensive measures to dispel uncertainty in the financial sector will only prolong the crisis, regardless of the firmness of the monetary and fiscal stance and the consequent turnaround of the current account deficits. The replication of such paths would only provide deflationary pressures to the world economy and foster competitive devaluations, worsening the crisis. Insecurity on the part of creditors and depositors regarding the solvency prospects of a financial institution, would lead to withdrawal of funds regardless of the tightness of the monetary and fiscal stance, keeping in mind further macroeconomic tightening could become counterproductive beyond some stage, where even sound institutions would become impaired. Decisive financial reforms while taking full advantage of the still strong fundamentals of most emerging economies would, in our view, be the more efficient way to stop the bleeding.

The working of the international financial system also deserves a brief comment. While admittedly the bulk of the responsibility lies with the poor design of financial regulatory infrastructure in the affected economies including, inter alia, lack of transparency, state intervention, inappropriate supervision of conglomerates, the incentives for the financial community to take positions in the emerging market economies also merit attention. Some emerging market economies with sound and well supervised financial systems have had difficulty in coping with strong capital inflows and in preventing the vicious circle of capital inflows, surges in domestic demand and asset prices, further monetary tightening and more capital inflows. It is appropriate to recall, therefore, that capital inflows in Southeast and East Asian countries were very large until very recently, that these were accompanied by generalized narrowing of risk premia in asset markets signifying a tendency to underestimate risk and that capital flows were to some extent driven by an imprudent move to higher yields. A reassessment of prudential standards, both in recipient countries as well as where major creditor banks are chartered, is necessary, specially given our commitment toward a freer environment for capital movement. By the same token, it is essential, as the interim World Economic Outlook states, to enforce rigorously the principle that private debts are private responsibilities, both for the debtor and for the lender. This chair expresses once again its concern about the moral hazard implications of this crisis resolution.

Mr. Toribio made the following statement:

I broadly share the analysis of the staff about the causes of the crisis in Southeast Asia and its subsequent extension to other Asian countries, like Korea. Overheating pressures, the artificial persistence of fixed exchange rates, and the weakness of the respective banking systems have undoubtedly played a central role in eroding the confidence of investors, and in creating the conditions for a deep financial turmoil.

I would like, however, to stress the importance of financial mismanagement in explaining the Asian crisis. The external debt of Thailand (50 percent of GDP) was, after all, not extremely high in terms of international standards and those of Indonesia and Korea (43 and 22 percent of the respective GDPs) were still lower. In all cases, however, there seems to be an acute liquidity problem, stemming from the fact that most of the outstanding foreign debt of those countries had been contracted in a short-term basis. In fact, the Asian banks had not only incurred in conventional solvency risks. By mismatching the maturity of loan and deposits, they also accepted an unnecessary large interest rate risk and by transforming dollar interbank deposits into domestic currency loans they run an additional exchange rate risk.

Poor underdeveloped countries are some times forced to follow that risky strategy because that is the only door opened to them by the international financial system. But that an economy as advanced as Korea (and to a lesser extent Thailand and Indonesia) chose to follow that narrow financial policy when they clearly had the option of diversifying their debt maturities and their currency liabilities in a globalized financial market is a kind of mystery that has not been convincingly explained so far.

In the long run, the economic crisis of those countries may have been unavoidable, but by adopting "a priori" a more rational financial policy, they could have postponed its appearance long enough to adopt preventive policies. Certainly, as the last sentence of the staff's report reads, "nothing has been demonstrated more clearly in this crisis than the critical importance of a robust and efficient banking sector for emerging market economies integrating with the global financial system."

In my view, once the crisis had developed, the Fund had two alternative ways to deal with it. The first would be to repeat the experience of the Mexican episode of 1994, providing enough resources and articulating enough policy measures in a coherent program to stimulate a balanced recovery of the economies with minimum damage to all the parties involved. The second alternative could have been to consider the problem, not country by country, but in a wider regional dimension, as something similar to the debt crisis of 1982. This second alternative would have called for a more complex approach, trying to distribute the costs among borrowers, lenders, and tax payers, under the leadership of multilateral institutions such as the Fund. Thus, a solution similar to the Brady plan could have been applied, with Japan playing the role the United States undertook during the debt crisis of 1982.

Despite the obvious problems of moral hazard involved, I still think we did the right thing in adopting the first approach. To being with, it was difficult to foresee the geographical boundaries of the crisis and how many countries would be finally affected. Besides, the East Asian economies have the resources to overcome the crisis in a relative short period of time, provided they closely follow the policy package agreed upon, as Mexico did during the past years. In that respect, I also share the staff's opinion about the probable "V" shape of this crisis, even though the rising portion may no longer reach the level these countries held in the past. If, however, the crisis were to affect a significant larger number of countries we should start to think about a different approach along the lines of the second alternative.

The conviction about the appropriateness of the path we have followed so far does not preclude the need to analyze how we could better face the problems of moral hazard that become more and more acute with each crisis we contribute to solve. These problems arise not on the part of the governments involved, but on the side of the lenders and investors, that enjoy a premium without actually running a higher risk. We have to find effective ways to make them share the cost of a crisis which they have helped to develop and from which they have profited. To be effective, the market discipline should include not only a reward for success but also a penalization for imprudence and mistakes.

Assuming that the financial crisis does not go beyond the current level, its effects on the American and Western European economies could well be what the staff suggests, in terms of slightly lower rate of growth, given the probable contractionary impact on exports and investment returns. It is even possible that such a cooling effect may turn out to be beneficial for those economies, in the sense of reducing the danger of renewed inflationary pressures and thus avoiding the need to adopt a stricter monetary stance. If, however, the crisis triggers a sudden correction of stock market prices (as it seemed to be the case last November), the subsequent wealth effect may be more serious. It is very difficult to predict at this stage which of the scenarios will finally prevail.

As for the economies of the troubled East Asian regions, I still find the staff forecast relatively optimistic both for 1997 and 1998. Of course, I would like to be wrong, but it seems to me that the region's rate of growth has a much higher probability of falling below, than of ending up above the predicted level.

Finally, I am not sure to fully share the staff's view on the prospects for Japan. In particular, it is hard to accept that, as the staff suggests (page 68), "there should be room for modest expansionary measures on the fiscal side, which would imply no further withdrawal of fiscal stimulus in 1998 following the substantial consolidation in 1997." For a country with a fiscal deficit equivalent to 5,4 percent of GDP (3 percent if we include social security) there seems to be no room for any kind of fiscal stimulus, however modest. In my opinion, the Japanese authorities should concentrate their efforts in accelerating the pending structural reforms and in strengthening the banking system, without jeopardizing the long-term fiscal consolidation, which is a precondition for a sustainable rate of growth.

Mr. Shaalan made the following statement:

I must first commend Mr. Mussa and his colleagues for an interesting analysis of the Southeast Asia crisis. In particular, the factors that led to the crisis as well as its evolution and the global linkages that contributed to its spread to other emerging economies as well the global economy are both illuminating and plausible. The staff analysis has been rightly tempered by the less than perfect knowledge of the main factors that contributed to the crisis and, more importantly, the uncertainties still surrounding its depth and evolution. It is clear that economic fundamentals do not explain these developments. Accordingly, I would view the analysis as preliminary and tentative.

The four sets of factors identified in the report as contributing to the present crisis are of course relevant. Leaving aside both the domestic and external factors leading to the massive inflows of the 1990s with which we can concur, an important factor, in my view, contributing to the crisis and its depth are the policy challenges associated with the heavy capital inflows. In particular, I would underscore the variety of weaknesses that characterize the financial sector, and, in the case of Korea particularly, the related weakness in the corporate sector. The financial sector could not intermediate and manage the sizable capital inflows in a productive manner. To my mind, this would suggest that an important prerequisite to capital account convertibility is a strong, highly developed, and well-regulated and supervised financial sector. The short-term nature of the capital inflows was very evident in the four Asian countries and, if I am not mistaken, these inflows, which in large measure represented borrowing by the banking sector for onlending to a highly leveraged corporate sector, accelerated in the early part of 1997 just before the onset of the crisis. These short-term inflows, coupled with the overheating that was clearly evident in a number of these countries, and with excessive credit growth collateralized by inflated asset prices and poor investment decisions resulted in what turned to be massive underutilized capacity. This has certainly weakened the financial sector and put into question the adequacy of the generally dollar-pegged exchange rate regimes.

Conceptually, it is a virtual truism that if problems were addressed early in the process and before the onset of a crisis, many of the serious problems we are now witnessing may not have materialized. Unfortunately, the phase of denial in every one of the Asian countries following, as it were, decades of success has only delayed the necessary corrective measures, not only to the detriment of the countries but to the rest of the world. A lesson: "complacency can lead to disaster." Once the crisis sets in, the options available to address it are more limited and difficult to implement, and in such an environment the markets have the well-known tendency to overreact, further aggravating the problem. The staff raises the question as to what can be done to encourage countries to deal effectively with already apparent problems. I don't profess to have any answers, but I am somewhat skeptical of the efficacy of using Article 12, Section 8, namely to publicize a country's economic malaise, if systemic problems arise from its economic management, as had been suggested in some quarters. Such action most likely would precipitate a crisis.

The staff analysis on the impact of the ongoing crisis on private capital flows to emerging markets appears reasonable. What is uncertain is the magnitude of the decline in the level and the change in the composition of capital inflows. These will be affected by the policy response of countries. In the future, contrary to the recent past, hopefully creditors will evaluate risks more than has been the case. Here, I wish to note that not only have the markets failed to foresee the financial problems, but the failure has in my view magnified the crisis. More short-term capital inflows had the inevitable consequence of more massive outflows when the crisis emerged.

The baseline scenario and the alternative scenario presented by the staff based on a time framework for the amelioration of the crisis is of course a distinct possibility, but there could be an equally plausible but more pessimistic scenario. One concern I have here is that the strong linkages between the two biggest economies in Asia (outside China), namely Japan and Korea, could pose serious problems for the world economy. In Japan the two most important areas that call for prompt action are the problems of the financial sector, which we are hopeful will be addressed forcefully and without delay, as well as the need to put in place a set of policies, including a temporary fiscal stimulus to begin the road to a domestic demand-led growth. Policy slippages in both or either of these two countries or a default by Korea could have serious repercussions beyond the region and including in the industrial countries—more than is presently envisaged by the staff.

On raising interest rates in the United States and Europe, I would like the staff and Mr. Kiekens to put that on hold for the time being.

I look forward to the next world economic outlook report, as well as the other papers on the subject where we are promised a thorough analysis of the financial crises in Asia and an identification of the appropriate lessons for preventive economic policies. As is well known, our reform package underpinned by massive resources has so far failed to stem the slide. Certainly, we at the Fund did not expect that the currency and equity markets would deteriorate to the extent they have. While I have no reason to doubt our policy advice, in our future assessments, we should not hesitate to address squarely the question of whether this advice is appropriate to the circumstances.

Specifically, while I don't profess to understand fully the relative importance of the underlying factors behind the present crisis, I would submit that three factors which we clearly see today in Southeast Asia are important as we look ahead. First, there is the deteriorating level of economic activity which is evident from the current private forecasts. Second, the so-far relentless currency depreciation, the extent of which certainly does not reflect the fundamentals, and, lastly, the high interest rates which of course reflect the increased perceived risks. These factors do have and will continue to have, if these trends continue, a devastating effect on the highly leveraged corporate sector and on the financial sector balance sheets. The interaction of the former with the latter could unfold a vicious circle leading to continued adverse behavior of the three factors I referred to. Accordingly, I believe that we should accord these consideration importance in our program design.

Ms. Srejber considered that, while the Fund should always be critical in assessing its policy advice, she would not be prepared at the present stage to change the Fund's policy prescriptions for Asian countries. Although the implementation of necessary corrective actions in those economies was proving to be very complicated, experience showed that consistency and market signaling was very important in crisis situations.

Mr. Shaalan said that he had not intended to draw any conclusions about the appropriateness of the Fund's policy prescriptions for Asian economies at the present stage. Rather, his comments had been intended to stress the need for the Fund to stand ready to reassess its actions.

Ms. Lissakers remarked that before the Fund began reassessing its policy advice to Asian economies, it should assess whether or not that advice was being followed. There was reason to question the commitment of many Asian countries in the implementation of policies recommended by the Fund, particularly with respect to monetary policy. For example, a recent communication from the Indonesian authorities suggested that they might not accept the Fund's monetary policy advice.

The Acting Chairman commented that, while it was important for Fund staff to keep an open mind, it was faced with important decisions each day. In the present circumstances, the Fund staff was making its best judgments on a daily basis. Of course, a great deal of internal examination and reassessment was taking place based on the outcomes achieved in individual cases. Also, a more thorough review of experience in the Asian crisis would be undertaken in the coming months.

While there might be some disagreement between the staff and the Indonesian authorities on the precise level of interest rates appropriate in the current circumstances, there was no difference between them on the need to maintain interest rates at high levels, the Acting Chairman said. As the staff paper for the current discussion showed, short-term interest rates were over 20 percent in each of the Asian economies undergoing Fund-supported programs. However, they had been below 20 percent in Korea, at least as of December 5, 1997.

Mr. Wijnholds noted that the staff paper showed that, although interest rates had risen sharply in Indonesia for a while, they had subsequently declined. It was doubtful whether a fluctuating pattern could send an appropriate signal to the markets on the authorities' preparedness to use interest rate policy vigorously.

Ms. Srejber commented that, while monetary policy alone could not solve financial and exchange market crises, it was important to keep monetary policy sufficiently tight in order to buy time for other necessary measures to be put into effect.

Mr. Taylor considered that there was a need for better communication, both among the Fund staff and between the staff and country authorities. There was a tendency in the Fund to conclude that interest rates were too tight or too loose, while interest rates, in fact, ran along a spectrum and needed to be judged on the circumstances prevailing in individual countries. For example, the staff paper for the current discussion suggested that the higher than average interest rates in the Philippines might help to explain why its exchange rate had not fallen as dramatically as those of some other countries involved in the Asian crisis. At the same time, however, the staff working with the Philippine authorities had expressed concerns that interest rates had not been raised enough. It should also be noted that the Philippines had not done a good job in terms of signaling the markets; there was still lingering confusion about the monetary policy stance there. It might be helpful for the Board to engage in a more focused discussion on monetary policy in individual Asian economies.

Mr. Esdar said that the appropriate stance of monetary policy could be gauged on the basis of whether or not it was sufficiently tight to stop capital outflows. That was particularly relevant in the case of the Asian economies.

Mr. Taylor stated that the Thai authorities seemed to differ with the staff somewhat on the importance of interest rate policy. The Philippine authorities also had different views from the staff on what was important in their economy. Some of the Asian countries did not hold achieving a certain exchange rate target as the primary objective of policy. In that respect, some of those countries might be taking a sanguine view about their capacity to bring inflation rates down in the future.

Mr. Zamani said that the authorities of the countries in his constituency were not considering a reduction of interest rates. Nevertheless, they were becoming increasingly frustrated by the continued decline in exchange rates, as the contagion effects of the crisis spread. There was a risk that increasing interest rates to very high levels might adversely affect the ability of firms to continue operations. That risk formed the basis of a pressing dilemma, namely, whether it was better to maintain very high interest rates and let firms go bankrupt or to allow the exchange rate to depreciate freely.

Ms. Srejber recalled that some of the countries in her constituency had faced a similar dilemma in the past. Experience in those countries showed that a freely falling exchange rate could make debts denominated in foreign currencies extremely expensive. However, it was even more costly for an economy to effect significant bankruptcies through overly tight policies. In such circumstances, market signaling was very important. Interest rates should be kept sufficiently high to stabilize the markets, while more fundamental reforms were being pursued. In that respect, an examination of the experience in Finland and Sweden could be helpful.

Mr. Zamani considered that the contagion effects of the current crisis in Asia were more severe and more widespread than in other recent crises.

Ms. Lissakers noted that a number of countries had gone through experiences that were similar to those in Asia in terms of the pressures that were brought to bear on policies and the need to address very difficult choices. Ms. Srejber was correct to point out the value of examining experience in other countries. While contagion effects had a role to play in the current crisis in Asia, the entire experience in that region could not be attributed to those effects alone. There were fundamental problems that needed to be resolved.

The comments put forward by Mr. Taylor and Mr. Zamani for the current discussion highlighted the need to examine the extent to which the Fund's advice was being followed, Ms. Lissakers remarked. In many of the countries concerned, the policies prescribed by the Fund were not, or at least not wholeheartedly, being implemented. Experience showed that those countries had tried the Fund's advice sporadically. Thus, part of the problem might lie in the confusing signals being sent to the markets and/or in the failure to pursue one policy stance long enough for it to have the desired effect.

Mr. Esdar said that he agreed with Ms. Lissakers and Ms. Srejber. Experience in past crises showed that monetary policy was the best instrument to be used in halting the spread of financial and exchange market crises, at least to buy the time needed to put in place other fundamental reforms. If interest rates of 20 percent could not halt the exchange rate devaluation, then they should be increased to higher levels.

Ms. Srejber stated that she agreed with Mr. Esdar and Ms. Lissakers.

Mr. Eyzaguirre commented that raising interest rates was clearly an appropriate policy course in the midst of a currency crisis. However, it was important to distinguish between crises that began in the current account and those that began in the financial system. The interaction between interest rates and the banking system was different in each of those situations. For example, raising interest rates might not be enough to halt the crisis if fundamental problems in the financial system were not also addressed. If doubts arose among depositors and creditors about their ability to reclaim their money, they might withdraw their capital even in an environment of very high interest rates. Thus, if the crisis arose in the financial sector, monetary policies should be tightened, but other reforms in the financial sector would also need to be taken. Appropriate monetary policies and structural reforms would be needed to stop the crisis.

Mr. Yoshimura considered that in situations like that prevailing in Asia the most important objective was to regain market confidence. If monetary tightening would help to build confidence, it should be pursued.

Mr. Sivaraman stated that he agreed with Mr. Eyzaguirre and Mr. Yoshimura.

Ms. Lissakers noted that Mr. Eyzaguirre's comments, suggesting that different monetary policies might be needed depending on whether the crisis began in the current account or in the banking sector should be examined carefully. It seemed that one of the reasons some of the Asian countries had been reluctant to tighten monetary policies was to ensure sufficient liquidity in the banking system and prevent bankruptcies. If that was the case, it should be borne in mind that any effort to avoid the allocation of losses would serve to prolong the crisis. As the experience of the U.S. savings and loans crisis demonstrated, the way in which losses were allocated both domestically and internationally would have a decisive impact on the ultimate length and severity of the crisis.

Ms. Srejber said that she agreed with Ms. Lissakers.

Mr. Esdar commented that he agreed with Ms. Lissakers. Although monetary policy was not a panacea, the crisis could not be resolved without monetary tightening.

Mr. Eyzaguirre stated that his comments were not meant to suggest that monetary policies should not be used. Rather, they were to point out that, in cases where crises arose as a result of financial sector problems, it was important to address two issues, namely, the cost of money and the prospects of getting repaid. If creditors and depositors had concerns that financial institutions might go bankrupt, they would withdraw capital, despite the maintenance of high interest rates.

Mr. Yoshimura made the following statement:

> At the outset, I would like to commend the staff for preparing a well-analyzed paper regarding the regional and global implications of the financial crisis in Southeast and East Asia under an extremely short time constraint.

Today, I would like to focus my comments on the Asian regional economies, as well as on the Japanese economy.

Regarding Southeast Asia and East Asian economies, as a general remark, to start with I would like to comment on the objectives of the World Economic Outlook report to be made public. There are, broadly speaking, two objectives I can see to be achieved by publishing the World Economic Outlook report. One is to point out inappropriate or delayed policy action to the economic development and ask for the early correction and implementation of policy measures. The other objective is to explain the policies actually taken, and to appeal to the general public and the market the fact that confidence in the economy should be recovered.

At this critical juncture of the Asian currency situation, when Thailand, Indonesia, and Korea are implementing the policies along the lines of the Fund program, and Japan decided to take bold measures to address its financial sector, while market uncertainty remains and confidence in the market has not been renewed, I believe the main emphasis in publishing this interim World Economic Outlook is definitely the latter, and the presentation of this report to the press and the public should be done so as to help the recovery of confidence in the market to the region and the Fund program. Excessive pessimism will not be helpful, not only for the global economy, but also for the reputation of the Fund. I hope the strong message encouraging the policy effort now being made in the region will be sent to the public by this report.

From this point of view, I have an impression that the interim World Economic Outlook paper as a whole puts more weight on the backward side by focusing on analyses of the past policy failures. Analyses of past policies is certainly important, but I think that it is appropriate as Fund strategy to pursue stabilizing market sentiment by paying more attention to the positive side, namely progress in policy responses in the recent months. It would also be appropriate to incorporate messages to encourage those relevant economies to take necessary measures in the coming months. I would appreciate comments by management, staff, and other Executive Directors on this point.

Let me now turn to some comments on the staff paper.

Regarding the background and factors of the financial crisis in the Asian region, the staff provided a compact analysis in section II, broadly in line with past analyses and Board discussions. As the paper indicated, we can list four critical factors as background for the crisis: the extremely successful economic performance of the Asian regional economies during the early 1990s; changes in external environment, particularly changes in monetary policies in industrialized economies; macroeconomic management and exchange arrangements; and financial sector and other structural weaknesses. Of these factors, as I have already mentioned several times, the problem of exchange rate schemes seems to be the most critical. I would also like to point to an additional important factor to which the staff paper paid little attention, namely political uncertainties. In fact, uncertainties in the political leadership in economies such as Thailand and South Korea seem to have led to the financial crisis, or have intensified it.

Regarding policy recommendations to the Asian regional economies facing financial crisis, the staff has provided a comprehensive and appropriate set of recommendations. I have no difficulty in supporting the argument that the following need to be core policy elements to overcome the crisis: tight fiscal and monetary policies, quick resolution of financial sector problems, and an improvement in corporate governance. However, in view of sending encouraging messages to restore market confidence, I think that the staff might consider adding more words to the paper on the recent positive policy responses of the relevant economies. The paper may at least incorporate the recent improvement of political leadership in the relevant countries. In Thailand, a new administration has contributed to reducing uncertainties. Indonesia has also started progress in tackling governance issues. An encouraging message to a new administration in South Korea could also be incorporated.

Although the staff provides a compact evaluation on the financial crisis itself, the paper paid little attention to the medium- and long-term growth potential that the Asian regional economies would still maintain. It is true that this crisis would be a challenge to the fundamental structural problems of the economies, such as rigid exchange rate systems, an unstable economic structure dependant upon short-term excessive capital inflows for massive investment, as well as a vulnerable and unmatured financial sector to smoothly intermediate massive capital inflows. However, it is shortsighted and inappropriate to deny the economic success so far of the Asian regional economies, as well as their growth potential by only taking into account their recent economic difficulties, although such pessimistic views may be observed among some market participants. In my opinion, these economies have preserved positive basic elements for high growth, such as diligent labor forces, high savings, and improvement of markets and infrastructures. I would therefore like to emphasize the fact that these economies will continue their high growth if once they succeed in sufficiently overcoming these economic difficulties. In view of the interim World Economic Outlook paper as an appropriate message to the markets, incorporating a medium-term evaluation on growth potential for the Asian regional economies might be considered.

Next, let me comment on the staff's policy recommendations.

Regarding monetary policy, it is a valuable lesson from the experiences of relevant economies that tight monetary policy is critical in a situation in which there is downward pressure on a currency. At the same time, however, it may be necessary to take into careful consideration making a monetary policy stance less tight when market confidence is sufficiently restored.

Regarding fiscal policy, I have no objection to the basic importance of keeping a prudent fiscal stance. However, we need to take into account the fact that many of the Asian economies that experienced financial crisis have maintained a sound fiscal stance for a long time. It is therefore difficult to answer to what extent these economies should pursue more fiscal consolidation, given maintaining considerable tight monetary policy. I have some doubts on the appropriateness of uniformly requesting a budget surplus to these economies, and I think that careful consideration on a case-by-case basis would be necessary to make policy recommendations to individual economies.

Furthermore, if each economy facing financial crisis simultaneously implements a considerable tight macroeconomic policy to constrain demand, these individual implementations might restrict improving each others' closely related economic performance. In such a case, there may be no denying that the Asian regional economy as a whole would fall into spiral deflation. If such a pessimistic scenario materialized, in light of the leading role of these economies for world economic growth during the 1990s, one can be concerned about its significant negative impacts on the world economy.

Finally, the paper does not provide a clear framework for the mechanism of contagion effects, although it analyzes well the domestic factors of individual economies affected by the financial crisis in the Asian region. I encourage the staff to make further analysis of the mechanism of the contagion effects in the World Economic Outlook paper next March. As a tentative hypothesis at this stage, I would note that supplementary and competitive relationships among the Asian regional economies could contribute to broadening the contagion effects in the region. In other words, in a case in which a currency is significantly depreciated, other currencies of neighboring countries might also have downward pressures to adjust external competitiveness. It is assumed that the Asian region has such economic relationships conducive to facilitating depreciation systematically. I would appreciate the staff's comments on this point.

Let me turn my comments to the Japanese economy. Its slow growth during 1995 turned higher in 1996, and its recovery trend lasted until the first quarter of 1997, when demand accelerated before the rise of the consumption tax. However, domestic demand decreased in the second quarter of the year, and economic conditions have not significantly recovered over the past two quarters. Positive signs remain to be seen in the indexes of investment and export sectors, and they are supporting the economy. Despite that, recently the uncertainties of economic prospects have been increasing due to the influence of the consumption tax being larger than expected, stock prices remain low and financial sector problems, such as failures of major financial institutions and, various structural problems, including the effective use of land. My authorities are well aware of the current situation and recognize that regaining the momentum of recovery and achievement of sustainable growth will contribute to the global economy as a whole.

Based on such stringent recognition of the current economic situation, my authorities already announced and implemented economic packages focusing on deregulation and structural adjustments. Furthermore, my authorities and the LDP have now been discussing further measures, such as decisive action regarding financial sector issues in an effort to wipe out uncertainties on economic prospects, and consolidation of the tax system, including corporate tax, in an attempt to revitalize the Japanese economy. As a concrete outcome to these discussions, the LDP today announced a fiscal package amounting to ten trillion yen to facilitate measures necessary to stabilize the financial system. These measures incorporate government guarantees on loans to the Deposit Insurance Corporation of Japan (DIC), consideration on issuance of government-guaranteed Bonds by the DIC, the strengthening of the Japanese version of RTC, utilization of taxation on land and financial securities, support for recapitalization of financial institutions, including capital infusion through purchase of preferred stock and/or subordinate bonds, and a package addressing the credit crunch of small- to medium-sized and intermediate-class companies. Also, the LDP today announced a draft proposal of a tax reform package focusing on corporate tax reducing the rate by three percent, a securities transaction tax, and a land value tax. The impact of the corporate tax is not officially estimated, but in my personal rough estimation, off the record, its impact will be just above one trillion yen. Based on these proposals, my authorities will make maximum efforts to implement more specific and effective fiscal and legislative measures at an early stage.

On the other hand, the biggest economic issue in Japan is fiscal structure reform. As I have repeatedly mentioned in previous Board meetings, the fiscal position in Japan is in the most critical condition among that of industrialized economies, and this issue should be addressed without delay. As an important first step, a fiscal structural reform law was finally passed in the Diet last month and, based on the legal framework, my authorities have taken further steps toward their target of reducing the fiscal deficit to 3 percent in the year 2003. In fact, general expenditure will be reduced in the fiscal 1998 year under the fiscal structural reform law. Undue diversion from the fiscal consolidation stance at this juncture will not only diminish my authorities' credibility, but also stress the uncertainties of the Japanese economy, and this could significantly hinge the recovery process.

To conclude the basic policy stance of my authorities, taking fully into account the recent stagnated economic situation, they would make every effort to strengthen the recovery trend of the economy by taking all possible measures, while not jeopardizing a framework for the fiscal structure reform.

I would, therefore, like to request an understanding that fiscal measures to stimulate the economy would be limited to those compatible with a framework for the fiscal structure reform.

The current version of the interim World Economic Outlook does not fully contain the recent progress made in policy discussions that I mentioned above. I therefore ask the staff to include the updated information with a fair assessment of the initiatives in the publicized version.

Finally, the crisis in east Asia and the issues of the Japanese economy should be analyzed as essentially different matters. The interim World Economic Outlook deals with them separately in its main part, but in the overview, which most of the readers and press will address, these two separate issues seem to be blended in the second paragraph. As this might confuse readers, I would ask the staff to clearly divide them into separate paragraphs. Also, I would ask the staff to edit the paper appropriately, reflecting my view as well as the Board's discussion on Japan.

Mr. Shields noted that Mr. Yoshimura had raised some important questions bearing on the presentation of the *World Economic Outlook* and the expectations the markets and the public might have of the Fund. It was very difficult in a crisis situation to strike an appropriate balance between economic risks, on the one hand, and the possibilities for success, on the other. In the circumstances, the overriding objective should be to present a balanced assessment of the current facts and the judgments drawn from them. Any tendency toward extreme optimism would likely be received badly by the markets and could undermine the credibility of the *World Economic Outlook* itself. The forecasts contained in the staff paper for the current discussion accurately portrayed the risks involved in the current situation. The risks to those forecasts were likely on the downside, although there was clearly the hope that corrective policies would be put in place soon and that market confidence and economic activity would be restored quickly. However, those were aspirations at the present stage.

It would be difficult at the present stage to incorporate into the *World Economic Outlook* the most recent policy proposals emerging in Japan, Mr. Shields considered. It was not yet entirely clear exactly what those proposals might entail or what implications they might have for the economic outlook. In the present circumstances, it might be dangerous to make bold statements about what policies might be adopted in the near future.

Mr. Toribio asked whether Mr. Yoshimura meant to suggest that the recent proposals to strengthen the financial system in Japan would lead to an increase in Japan's fiscal deficit for 1998.

Mr. Yoshimura said that he could agree with the comments put forward by Mr. Shields on the presentation of the *World Economic Outlook* if the Fund was a third party in the Asian crisis and its role was that of an independent research institute commenting on global economic developments. However, the Fund had an important role in developments in Asia; it was providing fundamental policy advice to the countries concerned and taking a leading role in providing finance in support of efforts to correct economic problems. The countries in Asia were making every effort to put in place the policy measures recommended by the Fund. Given that role, it would be appropriate for the Fund to send encouraging signals to the countries implementing Fund-supported programs and to the markets to help restore confidence. Such signals should be beneficial to the Fund's credibility, in terms of the programs it supported. Of course, if the countries involved did not fully implement necessary corrective measures, the Fund would need to communicate with the authorities on the need to do so, but that would be a different matter from the messages conveyed to the markets and to the public.

The recently proposed fiscal measures in Japan, which were aimed at strengthening the financial sector, were a reaction by the Japanese authorities to a request from the Fund, Mr. Yoshimura stated. In his recent visit to Japan, the Managing Director had encouraged the authorities to consider using further injections of public money to stabilize the financial sector. It should be possible at the present stage to incorporate those measures in the published *World Economic Outlook*.

The additional funds to be injected into the financial sector would be finance through the promissory note by the Japanese government to the Deposit Insurance Corporation, Mr. Yoshimura noted. As the entire amount of funding, ¥10 trillion, would be used over time, that amount would not be included in the official budget for FY 1998. Therefore, it would not be explicitly shown in the fiscal budget as a deficit.

Mr. Mori made the following statement:

> Under the current circumstances, a cautious approach seems to be appropriate in assessing the economic outlook. It is encouraging that growth in the advanced countries of North America and Western Europe appears to be sustained in the period ahead. However, we should not disregard the possibility that these countries, together with Japan, could be affected by much lower growth in their export markets. If the current financial problems in Asia persist and spread to other regions, the impact may be much more significant as trade and earnings of firms in industrial countries with interests in developing economies would be considerably reduced. In response to declining capital inflows, adjustment in emerging market economies has relied basically on a forced deceleration of growth to attain improvements in the current account position.
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> In this context, with this group of countries experiencing simultaneously a contractionary process, we agree with the staff that growth of domestic demand in other countries—particularly industrial countries—needs to be sufficiently robust for a global expansion to be reasonably well sustained. Therefore, support from the advanced economies is essential to contain the crisis. Macroeconomic policies in these economies have to be supportive to prevent further turbulence in the currency markets, and to provide the appropriate environment to contain the sharp process of reallocation of international resources.
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> From the global perspective, whenever there is an asymmetry in the growth cycle among economies, it is beneficial that countries with better performance could face deterioration in their external position, which would support activities and provide the thrust for recovery in economies with weaker growth through improvements in their exports. As the staff noted, strong domestic demand growth and widening current account deficits in emerging economies helped to sustain global growth when demand was weak in a number of industrial countries. Therefore, industrial countries, in their turn, may also play an important role in supporting global growth in this current uncertain juncture.
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> In this respect, a better policy complementarity between countries in different stages of growth cycle is desirable to allow a smooth transition process. This process, however, has not occurred in an orderly fashion. Imperfections in the international financial intermediation—either in the country where the resources originate or in the capital host country—have been one difficulty. For instance, capital movements to developing economies have occurred in surges with periods of large inflows followed by sudden and significant reductions in financial resources available for these economies.

When inflows are excessive, they may generate domestic as well as external imbalances in the host economies, and the sudden reversal may cause major disruptions.

While implementation of sound domestic policies in the host countries is essential, appropriate macroeconomic policies in the advanced economies are also necessary to avoid these excessive and distortive fluctuations in capital flows. When the level of interest rates is very low and economic growth is sluggish in the advanced economies, the excess of financial resources not absorbed in their domestic market tends to flow to economies with better economic prospects, particularly emerging market countries. Large amounts of resources, mainly short term, move from advanced economies to emerging market countries experiencing an expansionary growth cycle, seeking higher return investments and asset yields. When conditions in the advanced economies improve with better growth prospects and/or increase in asset yields, these financial resources tend to reverse, in most cases abruptly, creating major disruptions in emerging economies.

The World Economic Outlook addresses this important factor in assessing the causes of external financial turbulence in emerging market countries, namely, the level of international liquidity which is beyond the control of these countries. This environment has persisted since the early 1990s as most of the major industrial countries have experienced weak economic performance in this period, and as a consequence their monetary policies were significantly eased. Under these circumstances, the emerging market countries have faced two adverse effects, first, an appreciation of their real exchange rates as a result of large capital inflows, and, second, the widening of the current account particularly with the deterioration in the trade account. We have observed that this outcome has occurred in a wide range of countries with different patterns of fiscal and monetary policies, as well as exchange rate regimes.

Therefore, in a context of high and prolonged external liquidity, there occurs a conflict of policy objectives as between preservation of price stability, and maintenance of external balance. A specific structure—such as pattern of trade—and rigidities in small economies could generate such a policy conflict and, eventually, lead to unsustainable imbalances. However, to assess properly the current crisis—as well as other developments in the 1990s—the scope should not be restricted to emerging market countries affected by the problem. A more comprehensive analysis is required, including assessment of policies in the major advanced countries and their impact on a small economy, especially regarding monetary policy transmission. In a global perspective, the design—or constraints—of an appropriate policy response by small countries to correct domestic or external imbalances has to take into consideration effects on their economies of policies conducted by major economies.

Finally, a word on Brazil. As mentioned by Mr. Mussa, in response to recent turbulence in the international financial market, the authorities took action in the monetary and fiscal fronts to contain pressures in the currency market. Monetary policy has been tightened despite already high interest rates, and other policies have been implemented to keep them consistent with the primary objective of the stabilization program and in order to attain higher and sustainable growth in the longer run. In addition, the Congress has taken steps forward in the approval procedures of administrative and social security reform. In the structural area, the privatization process continued with the selling of electricity companies of states, while investments in infrastructure—as well as transfers to the private sector of the management of some ports, railways and roads—have been improving economic efficiency and competitiveness. And the authorities have also continued in their efforts to restructuring the banking sector—public and private—and to strengthen prudential regulations.

Mr. O'Loghlin made the following statement:

The ongoing episode of financial market turmoil in Southeast and East Asia has led economic forecasters, private and official alike, to revisit their projections. We therefore welcome this interim assessment of the World Economic Outlook, and would like to express our appreciation to the staff for preparing an insightful, but concise, synopsis of these events and their impact on the world economy under difficult circumstances; and to Mr. Mussa for focusing us on some of the key issues in his usual informative, but entertaining, fashion.

We all recognize that events are still unfolding, and that the outlook therefore remains highly uncertain, particularly as the extent of the shock in Asian economies and the policy response of the authorities are still unclear. In this context, we broadly share the staff's diagnosis of the problems, and their outline of the lessons learned. It is important to distill these lessons so as to help prevent future crises, although we are of course mindful that not all crises can be prevented. We look forward to a more thorough discussion of lessons learned from the crisis when we assess the World Economic Outlook in the Spring, by which time we hope the storm clouds will have given way to clearer skies. In addition, the paper on Lessons from the Thai Experience and the next Surveillance Review will provide us with further food for thought and discussion.

Before turning to a consideration of how the economic outlook has changed, let me first underscore some key lessons we take from the crisis:

First, a country can be characterized by sound fundamentals, such as high savings and investment, strong productivity growth, and a sound fiscal position, yet still be vulnerable to sudden shifts in investor sentiment. Accordingly, governments must avoid complacency when things appear to be going well; the need for prudent economic policies is unremitting. Addressing domestic and external imbalances, maintaining low inflation, and promoting private sector activity and the free functioning of markets are always key to sustaining prosperity. In the Asian context, in responding to present imbalances, we must be careful, however, not to put too much emphasis on fiscal restraint. Procyclical fiscal policy at this stage will make it more difficult for the affected countries to recover. The expenditure switching on the external side which will result from the depreciation will, itself, ensure substantial adjustment. On monetary policy in the Asian context, could the staff indicate what degree of pass-through of the depreciation to the price level they have assumed in their projections. I would think that a partial pass-through to the price level should be anticipated, but that no pick-up in underlying inflation should emerge inter alia given that high real interest rates—unfortunately—are a necessary component of the response to crises like these.

Second, the role of the exchange rate regime has been an important element in the Asian financial crises, with countries holding on too tightly to fixed regimes and eventually being forced to allow greater exchange rate flexibility, at a substantial cost. Expectations of indefinite exchange rate fixity contributed to a significant buildup in private external debt, much of it unhedged. By providing two-sided risk, a flexible exchange rate regime avoids this problem, and, more generally, better mitigates a crisis once it occurs. We would agree that a flexible exchange rate is not a panacea and cannot correct other policy deficiencies, but it can be an important element of an overall crisis avoidance strategy. I therefore welcome the background paper on Exit Strategies which identifies policies that can facilitate the transition to greater exchange rate flexibility and look forward to a thorough Board discussion of this paper at a later date;

Third, the crises in Asia highlight the risks involved in inadequate financial sector prudential supervision which had allowed banking systems to become weak, poorly managed and overexposed. Clearly, prudential oversight and banking regulation in emerging countries need to be strengthened;

Fourth, governments should strive to be transparent about their operations, about the true state of financial sectors, and about the links between banks, industry and government and the economic implications of those links. Countries, especially those accessing international capital markets, should recognize the importance of publishing timely, accurate, and comprehensive data, particularly with regard to the international reserves position, but also with respect to short-term external debt and prudential-type banking indicators. This would certainly respond to the failure of financial market participants to assess risks, and the consequences of that, to which Mr. Shaalan referred.

I would also like to touch on two other facets of the Asian crisis. First, we fully concur with the staff's view that speculators played a relatively limited role in the crisis. It is easy, but also inappropriate, to blame the speculators, which is akin to blaming the messenger. Like the staff, we would counsel policy makers to work on domestic solutions rather than blaming others for the currency turmoil, and to act in a timely and appropriate manner. Indeed, domestic residents' move to reduce their large foreign currency exposure was one of the most important factors in the crisis. In this context, we are not sure if we share the staff's call for advanced economies to offer supportive conditions in international capital markets to aid in the recovery of the Asian economies. We would tend to believe that domestic policies should be oriented toward domestic conditions.

Second, the oft-cited problem of moral hazard in the context of the Fund financial assistance to countries in crisis is impossible to avoid, but possible to mitigate. While it is unlikely, given Fund conditionality and the political fallout associated with seeking Fund assistance, that governments would follow overly expansionary policies due to the existence of a Fund safety net, the actions of private agents may be distorted by the expectation of international bailouts. Since such bailouts are part of an incentive-distorting chain of guarantees that also include fixed exchange rates and implicit or explicit credit guarantees, we must find ways to break that chain.

On the economic outlook, the downward adjustment to global growth is largely accounted for by sharp adjustments in the affected Asian countries themselves. But spillover effects are expected to lead to lower growth in other developing country regions, as well as in the advanced economies, most notably in Japan. As the projections are predicated on the prompt and forceful implementation of appropriate macroeconomic and structural policies in the affected countries, given progress to date we are concerned about the possible downside risks. It appears that the staff forecasts for Thailand, Indonesia and Korea are more optimistic than those published most recently by private sector analysts, some of whom are predicting an output contraction during 1998 in those economies. I note that post-forecast developments have led Mr. Mussa to also view the present forecasts as optimistic. In evaluating forecast risks, an assessment of other problem countries which are vulnerable to a financial crisis in the near term would be useful. Does the staff have any observations on this point?

Among the advanced countries, particular uncertainty attaches to the outlook for Japan, given the country's close trade links in the Asian region and the fragility of the Japanese financial sector. The unexpectedly large decline in activity in the second quarter suggests that economic recovery was not on a solid footing even before the crisis in Asia erupted. In that context, we believe that the monetary authorities should continue to support the economy with low interest rates, while a reduction in the pace of fiscal consolidation in the short term seems warranted. In addition, prompt and decisive actions are needed to address the Japanese financial sector problems. We therefore welcome the financial stabilization package which Mr. Yoshimura has outlined just now. The depreciation of the yen vis-à-vis the currencies of the other major industrial countries is a welcome development, although on an effective basis the yen is currently still somewhat stronger than at the beginning of the year, owing to its sharp appreciation against the currencies of other Asian countries.

Coming closer to home, we tend to concur with the staff's analysis of the implications of the Asian crisis for Canada. While any impact on Canada through direct trade links is likely to be limited, given the small share of Canadian exports absorbed by the region (about 8 percent of total exports), lower commodity prices and third-country effects could be more significant. Thus, slower activity and global deflationary pressures could lead to further weakness in commodity prices, which would tend to put downward pressure on the Canadian dollar. A sharp decline in the dollar would elicit an increase in interest rates to rebalance overall monetary conditions, with attendant negative confidence effects. Since developments in commodity markets affect a broad range of countries, a more thorough assessment of prospects for commodity prices might be useful.

The other risk to the Canadian outlook, namely a significant impact on U.S. growth from the Asian crisis, is also a concern. For the time being, the view that the deflationary shocks emanating from Asia will have a salutary effect on the U.S. economy, allowing monetary authorities there to delay a further modest tightening of policy, seems reasonable. As for the future course of monetary policy in Canada, some moderation in the degree of monetary stimulus will be needed over the medium term to achieve a sustainable pace of expansion with low inflation. In this regard, I should note that the Bank of Canada raised its Bank Rate by 50 basis points to 4.5 percent on December 12, a move aimed at helping to settle domestic markets, which, like others, were affected by events in Asia.

Mr. Wijnholds made the following statement:

I appreciate the staff's efforts in preparing this document. Given the lack of time, the still unfolding crisis in Asia and the need for prudence in a paper to be published, it is understandable that the analysis is somewhat tentative. More depth and more information will no doubt be available when the staff produces the spring World Economic Outlook paper.

The staff describes its baseline scenario as cautiously optimistic. World output is not affected much and Asian countries can look forward to avoiding a recession, except for Thailand for which zero growth is projected. In this scenario the Asian crisis almost comes across as a blessing in disguise, especially for North America and some European countries which are approaching a state of overheating. Apparently the staff is not entirely comfortable with this scenario and sees a 'tension' through the current account balance projections. Mr. Mussa in his oral statement brought out that the baseline scenario may be too optimistic. While this is not an official Board document, I am worried that we will be seen to be lagging behind developments if we present it as our main projection.

The containment scenario (no. 2 of the alternative scenario's) might well be a more likely outcome. For instance, I find it rather hard to imagine that Korea and Malaysia will still be able to maintain a 2.5 percent, and Indonesia a 2 percent growth rate next year in light of the most recent developments. Then there is the scenario of the long-term decline in financing flows to emerging market economies, which could be dubbed the cautiously pessimistic projection. World GDP is further reduced by about three quarter percent in the first two years, and emerging markets' growth by a multiple of that.

One can also distinguish a fourth and fifth scenario, namely a highly optimistic one and an unmentionable one. It seems that some of the Asian authorities were until recently working on the basis of a highly optimistic—or denial—scenario, maintaining that their growth rates need hardly decline. The resistance to accepting lower growth rates for a while has been considerable and has exacerbated the crisis for a lack of willingness to adjust, particularly in the area of monetary policy.

The unmentionable scenario is the one that was probably at the back of the minds of many of us when we decided to go along with huge financing packages for a number of countries. The implicit notion is that if such financial support were not provided, the consequences could be so severe as to be unacceptable. The weakness of the banking system in a major country has no doubt played a major role in this regard. While not fit for publication, I would be interested in hearing the staff's oral assessment of the consequences of a default or moratorium on Korea's short term external obligations.

The description of the crisis is clear and to the point. In particular, the description of the financial sector and other weaknesses in Korea is enlightening and in sharp contrast with last year's Article IV consultation report for that country. It is unfortunate that the Board remained pretty much in the dark on the emerging problems, leading to what was a too positive summing up that is now being understandably criticized in the press.

On page 37 it is mentioned that after intervening heavily to support the won, the authorities "subsequently requested financial support from the Fund." I think it is important to bring about more clearly here that the long period of hesitation by the authorities to approach the Fund, the lack of willingness to increase interest rates and the lack of transparency with respect to the usability of reported international reserves. This is after all one of the clearest lessons to be drawn from the crisis: waiting too long to turn to the Fund and hiding relevant facts only makes things worse.

On the same page mention is made of the fact that Greece, Russia and Ukraine were affected by the crisis. Should not Hungary and Turkey be mentioned here too? It may also be useful to mention that the problems in Russia and Ukraine were exacerbated by the circumstance that a considerable share of their treasury bills were held by nonresidents from emerging market economies, including Korea. A case of very direct contagion.

As to policy considerations, the staff is right that the intensity of the crisis took everybody by surprise. I would, however, not go so far as to say that such events are inherently nonforecastable. Had we known the true level of Korea's usable reserves as well as of its short-term external debt, most of us would have been a lot more worried than we were, say at the time the Thai crisis emerged. And while it is true that the staff had repeatedly warned in previous World Economic Outlook's about the risks associated with overheating and unsustainable external positions, and that warnings were also communicated through other channels of surveillance, it appears that in the case of Korea there was a failure to recognize the seriousness of the threat. Mr. Kiekens graciously states that 'even this Board' failed to foresee the problems that lay ahead. But the Board itself has to rely mainly on staff reports in making its judgments. The alternative to have outside experts to aid us, as suggested by some academics, does not appeal to me. We probably have found the right approach in having external evaluations, and it is envisaged that the next one will deal with surveillance.

On page 64 the staff explains that besides economic policy mistakes the situation in advanced economies also contributed to the buildup of imbalances that eventually led to the crisis. I fully agree that the sometimes aggressive search for high yields by international investors led to excessive international lending, which, incidentally, many observers were slow to recognize. An ample supply of international liquid funds contributed to this development. The staff attempts to link this to weak growth in Japan and Europe. I find this a little tenuous as far as Europe is concerned, where growth was not all that weak, namely 2.5, 1.7 and 2.6 percent in 1995–97. But if we are to mention all contributing factors, why not also mention the effects of U.S. balance of payments deficits? Another factor contributing to the large-scale lending to emerging market economies may have been the expectation among lenders of a bailout by the Fund in case things went wrong, given the experience with the Mexican crisis.

On page 67 I would rephrase the sentence "the international community also must help to contain the crisis" by substituting the worlds "also must help" by "is helping." I also do not agree (in the next sentence) with the implication that this necessarily requires substantial financial support from the Fund. I would prefer simply stating that such packages have been provided without making a normative statement. In fact, the argument that large scale financing packages are needed could be seen as to be at odds with the statement on page 65 that "governments have a clear responsibility not to assume, or place themselves in a position where they might be thought likely to assume, private sector obligations that would threaten their solvency." I would also point to what could be seen as perverse effects arising from the current financial packages. Creditors which have provided short-term dollar-denominated financing are seen to be bailed out, while providers of more long-term financing are taking a loss.

I also have a few remarks on banking statistics. In Table 2 the inclusion of Hong Kong and Singapore is a little misleading as these are international financial centers and most of the outstanding claims are of a purely interbank character not indicating end use. Better to mention claims on these centers separately. I would also suggest to indicate the extent to which these loans are short term. A caveat is also in order, as these figures do not capture the full extent of international bank lending, as they do not include data for claims of the nonindustrial Asian countries among themselves. In this regard the degree of financial linkage between these countries is difficult to determine, also making more complex the assessment of possible (real) contagion effects. An improvement in the availability of intra-Asian financial data would seem an important area of future work.

Finally, I welcome the announcement of the Japanese measures, but it is unclear what the impact will be, especially as regards combating the weaknesses in the banking system. Here, staff, management and the Board have long been on record in warning of the negative consequences of protracted delay of tackling this problem. We look forward to a leadership role that Japan can and should play in the present unsettled situation in Asia.

Mr. Zhang made the following statement:

I welcome today's timely meeting on the interim assessment of the World Economic Outlook. And I would also like to join other Directors in thanking the staff for providing us with well-prepared papers on the world economy, especially in the face of the financial turmoil in Asia. I agree with Mr. Wijnholds that Mr. Mussa's representation is both excellent and important. I would like to see that Mr. Mussa's statement is circulated. I broadly agree with the staff assessment in the paper and shall focus my comments on a few areas.

On the causes of this turmoil, I agree with the four sets of factors that the staff has put down. I also agree with Mr. Kiekens that the crisis was not caused by any single factor, but by the particular way in which several factors interacted. However, I would like to emphasize that the current crisis took place in the economies where inflation has been kept on a relatively low level and economic growth maintained at a relatively high rate. It clearly shows that capital account liberalization and globalization have posed new challenges for macroeconomic management, especially from the sudden reversal of capital flows.

The current episode in Asia has its roots in three areas which are markedly different from previous economic difficulties: first, excessive private sector borrowing, especially in short-term external debt without due regard to the risks involved; second, misallocation of resources, especially over-investment in real estate and the manufacturing capacity that adversely impacted on productivity and competitiveness; third, an abrupt weakening of confidence that has result in a flight to quality. The lack of confidence is also associated with policy errors, financial fragilities, and questions of transparency and governance.

Looking back to the recent economic development, emerging Asian economies grew rapidly in the early nineties. During the same period, industrial economies, including Japan and Europe, were on the side of relatively weak growth. In search of investment opportunities, capital flowed from these countries into Asia and fueled investment and economic expansion. Both governments and private investors had not paid due regard to the external imbalance, asset price bubbles, and structural weaknesses. What is more serious is that emerging market economies in Asia had to cope with the potential reversal of capital flows, when in the mid-nineties, particularly in early 1997 the major industrialized economies were generally growing strongly.

On the part of capital recipient countries, this episode reveals the vulnerabilities of banking systems in coping with the volatility of capital flows. On this, I emphasize the importance of sound macroeconomic management and prudential supervision. More precisely:

First, macroeconomic policies should be directed to address promptly any excessive overheating pressures and asset price bubbles;

Second, supervision should be strengthened with standards brought up to international prudential standards, i.e. the Basle standard, including capital adequacy ratio, liquidity ratio, and loan classification. There should be stringent enforcement of the regulatory rules. Moreover, as the supervisory authorities need to keep pace with the rapid developments in the financial markets and many members have yet to acquire the capacity to cope with the complexities in the financial sector, I call upon the Fund to pay special attention to them and provide assistance to member countries in this respect. As I said yesterday when we discussed the establishment of the Supplemental Reserve Facility, the Fund should not only help members to overcome the current difficulties, but also to build up capability to resist possible attacks in the future.

Third, capital account liberalization should be paced in a steady and orderly manner. Only with a robust financial system can the full benefits of liberalization be reaped and, more importantly, the risks be minimized.

Fourth, external debt, especially short-term borrowing, should be monitored closely. Again, this relates closely to the issue of transparency and corporate governance. A long-term solution to this problem is for Asia to develop a deep, liquid and mature debt market for effective and efficient intermediation. This would enhance greater compliance with international standards of disclosure and subject enterprises to market discipline.

As regards the role of the exchange rate regime in capital recipient economies, I hold the view that it is a matter of whether the regime is well supported by appropriate macroeconomic policies, sound fundamentals, and a robust the financial system, rather than a matter of the choice of regime. The choice of regime should depend on a number of considerations, such as the size and openness of the economy. No single regime suits all economies, and no regime is always superior to another. In addition, while we pay great attention to the real exchange rate in assessing the competitiveness of an economy, we must also stress the differences in the structure of various economies, such as import content and productivity.

On the part of capital exporting economies, I urge that their macroeconomic policies, while taken independently on domestic considerations, should be coordinated among themselves, with due consideration given to global implications. A stable international environment, especially in respect of exchange and interest rates of major currencies, is certainly important for the adjustment of the affected countries to be carried out smoothly and help contain the downside risks of the current turmoil.

Turning to the policy response of the affected countries. They have already charted the right course in addressing the structural weaknesses in the financial and corporate sector, with assistance from the Fund and other multilateral institutions. Here, we underscore the importance for the authorities to demonstrate strong commitment and determination in taking the painful steps, so as to resume investor confidence. This, I believe, is the best way to contain the contagion and the impact on the international monetary system. While understanding that policy tightening is an indication of the program's credibility, as I have pointed out in other occasions, we should also look carefully into finding the optimal level to avoid adding additional recessionary impulse to the affected economies.

Coming back to the economic forecasts, I think that in face of the close trade and financial links among industrialized economies and the emerging market economies, the Asian flu will have a considerable impact on the Asian turmoil on world growth. On this, I agree with the staff's downward revision in the growth forecasts in most cases and caution the forecasts' downside risks should there be a slower return of investor confidence or less than favorable international financial environment, say too tight monetary conditions or excessive movement in major currencies. However, I would like to support Mr. Yoshimura's suggestion for a more forward-looking approach in the World Economic Outlook.

Therefore, I would like to say that "crisis" in a Chinese context is made up of two parts—risk and opportunities. Notwithstanding the short-term difficulties faced by emerging Asian economies, including sharp capital outflows and economic slowdown, I believe that Asian economies, with high savings rates, prudent fiscal polices, and small current account imbalances, should turn the crisis situation into an opportunity for learning lessons, and rectifying the fundamental and structural weaknesses. This should provide a sound basis for strong growth in the future.

Mr. Cippa made the following statement:

Like others, I would like to thank Mr. Mussa and the staff for providing a very interesting and timely report on the causes and effects of the recent crisis in Asia.

At the outset, let me say that we agree with Mr. Mussa's oral presentation: like him, we also consider the revised projections contained in the basic scenario of the interim assessment of the World Economic Outlook as too optimistic. Incidentally, in this respect I share Mr. Wijnholds' concern about publishing it in its present form. Indeed, concerns about the authorities' commitment to reform, and public disapproval of the Fund's rescue plans in some countries of the region would suggest that expecting a rapid recovery as experienced in Latin America may not be too realistic. Moreover, the pre-crisis situation was characterized by risk premiums that did not fully reflect the risk the investors were taking. Therefore, we think that retaining the more pessimistic scenario (scenario I) presented by the staff would be more appropriate. The decline of capital flows to emerging markets could even be more substantial than expected in the three MULTIMOD simulations. This would entail a much greater slowdown in domestic demand and growth. As a consequence, there would be some additional dampening effects on growth in industrial countries caused by the need to absorb the adjustment in current accounts of emerging markets.

The impact on real GDP growth in industrial countries, however, would be contained (with the exception of Japan). Indeed, respective shares of trade with emerging markets economies when weighted by the ratios of trade to GDP are too small to have a significant effect. Moreover, inflation prospects and the state of the labor market in most European countries provide them with a comfortable margin to counteract an adverse external shock by an appropriate accommodating monetary policy. Therefore we believe that European economies will remain on the ascendant path of their business cycle, as indicated by the recent improvement of the consumption climate and industrial production confidence indices, and that the robust upswing in North America will continue. In this sense, I agree with Mr. Mussa that the crisis in Asia could hardly come at a better time.

Turning to the causes of the financial crisis, I am in broad agreement with the staff's analysis. Until the breakout of the crisis foreign investors' mood was upbeat regarding the prospects of most countries of East Asia. Regional growth had been impressive and sustained, standard indicators suggested macroeconomic stability. Furthermore, in most cases foreign exchange arrangements made currency risks look minor. In addition, foreign capital was plentiful for emerging markets due to accommodative monetary policies in many weak performing industrial countries with relatively low interest rates. In hindsight, this mixture of positively perceived factors led to widespread imprudent behavior of foreign investors, domestic enterprises and emerging markets' governments.

In their euphoria, investors ignored the structural weaknesses of many of the Asian economies. Imbalances that were reflected in sizable current account deficits, pressure in the foreign exchange markets, booms in real-estate and equity markets and the size and time structure of the external debt remained unnoticed despite various whistle-blowers. When the first signs of a crisis buildup surfaced, investors' panicked and ran for the exit. However, it is fair to say that while the sudden change of investors' sentiment pulled the trigger to the crisis, its fundamental cause lies elsewhere.

We do not deny that external events contributed to the buildup of certain imbalances in the Asian countries under discussion. However, the crucial mistakes were essentially homemade. Structural weaknesses are at the root of the problems of the countries affected. Too much political and bureaucratic interference in the economic system combined with a high degree of intransparency led to a substantial misallocation of resources. This is particularly true with respect to inefficient financial sectors which were overstrained by the massive capital inflows. To a large extent, these inefficiencies—often for political reasons—are due to insufficient regulatory and supervisory frameworks which led banks and other financial intermediaries to imprudent lending.

In these circumstances, intervention alone in the foreign exchange market could not represent the adequate policy response neither could the floating alone of the currency. Initial actions taken by the respective authorities to accompany the floating of their currencies did not indicate a convincing enough willingness to cure the underlying problems in their economies. A tightening of monetary policy as well as a determined restructuring of the financial sector should have been initiated as soon as the crisis erupted. The floating of exchange rates would then have been understood as a measure among others, not as the panacea.

The crisis we are going through in Asia shows once more how crucial it is for any country to address its structural problems in a timely and decisive way. This is even more true in a globalized world with highly integrated financial markets. The painful Asian experience brought to the fore how important it is that governments and authorities refrain from interfering in the economic system beyond necessary regulation and supervision, especially in the financial sector. These countries have to delineate anew the division of labor between the public and the private sector. Good governance should foster national and international competition on the basis of market forces. Furthermore, special attention has to be given to the financial sector. The evolution of this sector should be driven by competitive forces within the framework of safe and sound regulation and supervision. This framework should be designed, implemented and enforced in line with internationally accepted standards and best practices.

When a crisis occurs and the risks of contagion are real, Fund intervention is required. Fund financial support, however, raises the issue of moral hazard. I do not want to elaborate on this, as I hope that we will have a Board discussion on the subject pretty soon. Let me only say that to reduce this risk, foreign private creditors should share part of the adjustment burden and face losses.

Finally, there is a strong case for better dissemination of information by the Fund on the economic situation of member countries. As shown by the recent downgrading of Korea by the rating agencies (e.g. S&P and Moody's), these agencies were not aware of the fragile nature of the financial and corporate practices in Korea against which the Fund had already warned the authorities in the past. Publication of such information would have led the agencies to revise their ratings earlier, which may have helped prevent the crisis. Such a policy may have a cost, in terms of making countries reluctant to provide the necessary confidential information to the Fund, but this cost would certainly not exceed that of the full-blown bailouts which we have just gone through.

Mr. Al-Tuwaijri made the following statement:

Let me join others in thanking the staff for producing this informative paper under a tight deadline and heavy work load. I found the review of the build up to, and evolution of, the crisis in Asia most useful. The downward revisions of growth prospects in all regions of the world underscore the high interdependence of economies and the benefits to all of increased cooperation and coordination focused on reducing the likelihood of future crises.

Turning to the details of the projections, I agree that capital flows to emerging markets will likely decline. The level of decline will depend largely on success in stopping the spread of the crisis. If the crisis spreads to another emerging market economy, the repercussions for capital flows to, and growth in, emerging economies could be severe. Such a scenario could also undermine confidence in the industrial countries, lead to a sharp drop in equity markets, and further dampen growth. Even without such a development, projections under the base line scenario seem somewhat optimistic. The continued decline in business confidence could weaken growth prospects in Japan with important spillover effects on industrial and developing countries. Therefore, it is important for Japan to take policy action to stimulate its economy and to address, in a comprehensive manner, problems in the financial sector which have been a major drag on growth. In this regard, I welcome Mr. Yoshimura's statement this morning.

Turning to the causes of the crisis in Asia, I believe the most relevant influences include:

First, recourse to large short-term foreign borrowing. This could be a direct result of high domestic interest rates, and easy access to low interest foreign debt. Intermediation of such borrowing by domestic banking sectors with limited capability to assess credit and exchange rate risks also played a major role. Complacency on the part of international financial institutions and willingness to supply short-term credit without adequately pricing the risks also exacerbated the situation. Here, it is interesting to note that while foreign direct and stock portfolio investment suffered heavy losses due to the crisis, the impact on foreign suppliers of short-term debt has been more limited. In fact, they have been effectively bailed out, first by blank government guarantees and then indirectly by external financial assistance to the concerned governments.

Second, regarding developments in the international financial markets, the recent crisis underscores the importance of stronger cooperation and coordination of the major industrial countries. The impact of sharp swings in the exchange rates and interest rates of the major economies on emerging and developing markets is enormous. These shifts impact capital flows and are directly linked to competitiveness, growth, and profitability. In this regard, I fully agree that further monetary tightening in North America and Europe should not be undertaken at this time.

Third, while I agree that speculators are not the root cause of the problem, by advancing the timing of the crisis they may have deprived the authorities of the needed time to put their house in order and therefore avert a crisis all together.

Turning to the measures implemented to address the crisis, I believe that stronger policy action at the outset of the crisis could have greatly contained the spillover effects. Here, I agree with Mr. Zoccali and Mr. Eyzaguirre that tougher and more decisive actions to restructure the financial system would have been useful.

Regarding the issue of how to encourage countries to deal effectively with economic and financial difficulties before a severe crisis occurs, I believe the difficulty is that these problems are not usually apparent until too late. While the staff has made a number of recommendations and voiced some concerns over economic developments in some emerging Asian economies, I do not believe a crisis, let alone one with such severity, was anticipated. As noted in Messrs. Kiekens and Jones' statement, this Board and the credit rating agencies also did not foresee the magnitude of the problem. While we should all continue to be vigilant and strengthen efforts to enhance the functioning of the financial sector, unnecessarily tight policies are not without costs.

The Executive Board recessed at 1:00 p.m. and reconvened at 3:15 p.m.

Mrs. Gonzalez made the following statement:

I thank Mr. Mussa for a clear presentation and the staff for an informative analysis of the causes and implications of the ongoing financial crisis in East Asia. There are various lessons that could be learned and should provide timely guidance to other countries. I broadly agree with the conclusions derived from the assessment but believe that certain sections could be further strengthened. Like Mr. Yoshimura, I believe that it would be helpful if the document presents in addition recent favorable developments in the countries principally affected by the crisis, including the progress made so far in implementing adjustments and reforms. The call is not for overoptimism but for a balanced reporting of both the upside and downside risks which should allow a better reassessment by markets of country risks and hopefully, a more rapid restoration in confidence in these countries. Judging from the reactions of markets to the Fund's policy prescriptions, it would be useful if the Fund could further clarify the need for a further tightening of financial policies, especially fiscal policies in all the countries concerned beyond what might be required to cover the costs of financial sector restructuring.

We agree on the principal underlying causes of the crisis—weaknesses in domestic policies, financial sector and other structural weaknesses; as well as developments in major industrial countries. Looking at the individual countries, these factors had varying influences to the crisis, with some more important than others. In Thailand, Indonesia and Korea, the problems could be attributed mainly to structural weaknesses in the financial sector as well as to problems with corporate governance especially in Korea. In the Philippines, the perceived relative rigidity of the exchange rate could have been the principal underlying factor and possibly the delay in the enactment of the remaining elements of the tax reform package. As Mr. Mussa noted this morning, the package had been passed. Other important differences in the underlying economic factors include exposure to short-term debt, export performance, and quality of bank balance sheets.

These differences could account for why countries belonging to the ASEAN-4 have been affected in varying degrees by the crisis, although one could argue that there have been substantial overshootings. The document could usefully provide an explanation of why the exchange rate and the stock market in the Philippines have been more stable compared to the other countries as mentioned in the second paragraph of page 37. We could offer some facts that could be cited which we would relay to the staff bilaterally. We recognize the complexity involved in presenting a detailed, case-by-case analysis because of time constraints but I believe that this is an absolute necessity given that there are significant differences in the circumstances of the countries under review.

The assessment correctly identified developments in industrial countries which contributed to the crisis. The growth slowdown in some of the countries had led to excess savings which were made available to developing countries at narrowing spreads, encouraging greater reliance by these countries on foreign funds and increasing exposure to foreign exchange risks. The reduction in demand for electronics also affected export performance in some countries while fluctuations in the yen-dollar exchange rates similarly influenced the external competitiveness of countries closely linked to the U.S. dollar.

The role of contagion may not have been adequately assessed and we look forward to a fuller discussion of this subject.

On policy lessons from the crisis, the reforms required to address structural weaknesses are clear, including the importance of an orderly phasing of capital account liberalization. Judging from the reactions from some independent observers, however, the Fund prescription for a further tightening of monetary and fiscal policies in all countries most severely affected by the Asian crisis is not well understood. Perhaps the Fund should provide more evidence about the efficacy of its policy advice on this area. (Mr. Mussa touched on this morning but it would be helpful if the arguments are also communicated outside the Board.) Indeed, the Fund has been sharply criticized about its stress on macroeconomic adjustments when macroeconomic fundamentals in the countries concerned have been generally strong.

Another area which needs to be reinforced would be the discussion of the appropriate approaches in dealing with problems of overheating, excessive credit growth and large capital inflows (page 21). The document discussed some of the difficulties associated with these approaches but stopped short of offering advice (or taking a position) as to what should be the most appropriate response under specific situations. It would be extremely useful for the document to be explicit in this regard.

The effects of the asset price deflation in Japan are still being felt. The World Economic Outlook could usefully have drawn the lessons from Japan's failure to bounce back that could be used in the present Asian crisis.

Given that the countries most affected by the crisis have put together comprehensive programs of adjustment and, with the exception of Malaysia, with the support of the Fund, we are optimistic that a forceful implementation of these programs would allow a restoration of market confidence reasonably quickly. Political pressures have, however, posed serious constraints on the implementation of needed adjustments and reforms. Recent developments highlight the critical need for authorities to demonstrate firm commitment to agreed actions, especially in the restructuring of the financial sector, minimizing government intervention in business activities and strengthening corporate governance. More recently, we have seen significant progress in this area and we anticipate further significant movements forward.

On the forecasts, there is still so much uncertainty in the system that it is difficult to tell what is likely to happen. I agree that the crisis has encouraged a general reassessment of country risks and that it is reasonable to expect a decline in capital flows to emerging markets as a whole, and a slowdown in growth in these countries as well as trade with others. The magnitude of the recovery in capital flows will be determined importantly, as others have noted, by the speed, and the breadth and depth of implementation of adjustments in these economies as well as by the recovery in advanced countries, mainly Japan.

With regard to multilateral and regional cooperation, the Fund had quickly come to the aid of members that faced severe short-term financing needs. The Supplemental Reserve Facility should further improve the effectiveness of the Fund in responding to such cases. Beyond this, I believe that the Fund can help restore market confidence by further clarifying how each country's framework for adjustment, especially the macroeconomic adjustments it supports would strengthen the foundations of the economies concerned. As suggested earlier, expanding the World Economic Outlook document to report on recent progress in the implementation of adjustments and reforms in the countries directly affected by the crisis would also be helpful.

Several issues relating to coordination between multilateral and regional institutions: Given that weaknesses in financial sector and corporate governance are the underlying problems in most of the countries most directly affected by the Asian crisis, what should be the role of the World Bank? How early should it get involved? Under the circumstances, is a clear separation of responsibilities between the Fund and the Bank realistic and practical? Is the Fund not going beyond its primary responsibilities by developing adjustment programs that cover these areas that may more properly belong to the World Bank? To what extent was the Bank involved in the design of the financial restructuring program in Thailand, Korea, and Indonesia? The Board had an earlier discussion on these issues but we look forward to the follow-up discussion which was agreed to at the suggestion of several Directors.

Enhancing regional cooperation, including the establishment of a regional surveillance mechanism was among the major recommendations that came out of the meeting of finance and central bank deputies in Manila last month and subsequently endorsed by the ASEAN finance ministers in their meeting in Kuala Lumpur. I believe that it would be useful to include this in the World Economic Outlook report by discussing the objectives of the mechanism, how it is expected to function, and the contribution and role of the Fund. How do the staff view the potential effectiveness of this mechanism in terms of strengthening policies in the region and preventing crises?

Finally, we have a number of suggestions on the wording of some statements in the document which we would communicate to the staff on a bilateral basis.

Mr. Sivaraman made the following statement:

I join other Directors in commending the staff for a very lucid and instructive presentation today. Like Mr. Yoshimura, I would suggest that we publish this paper, clearly articulating our warnings and advice, without fear that our prognosis may lead to self-fulfilling prophesies.

Warnings and advice issued in time, and properly acted upon, could at best lead to ripples in the economic system, rather than the kinds of trauma that economies have experienced recently. There are no multilateral institutions with more clout and universal membership than the Fund and the World Bank to deliver these messages.

I would also suggest that members be encouraged to have flexible exchange rate policies that are sufficiently within the control of authorities to enable them to diagnose deficiencies and take appropriate remedial action. Apart from the Southeast Asian countries, there are other countries with serious fiscal and financial sector problems. They should be encouraged to speed up reforms and tighten policies. I know the Fund staff and management has taken adequate steps with respect to some of the countries in my constituency, but with only a sluggish response from the authorities.

Although the Fund should assist crisis-ridden economies in their efforts to restore normalcy, we should not focus too much on restoring market confidence, as this could lead to a very narrow interpretation of our assistance; the players in the market have been no less responsible for the debacle in these countries than the weak domestic policies.

All developing economies should recognize the inherent limits on the ability of an economy to sustain a high rate of growth for a long period on borrowed capital. The Southeast Asian economies, with their high domestic savings and manageable current account deficits, in normal times should still be able to achieve high rates of growth without resorting to excessive borrowing. These economies have sustained high rates of growth with considerable dependence on exports. When other sources of competition emerge, export-led growth may encounter roadblocks. Therefore, careful attention should be paid to the development of domestic markets. Whether this should be through fiscal stimulation or other measures will depend on the individual country's situation.

While we should move toward capital account convertibility, we should be more cautious, and our advice should be based on individual country assessments. The capacity to carry out simultaneous reforms on all economic fronts may be limited in many countries that are in the nascent stages of development and do not have the proper legal and institutional frameworks in place. To push these countries simultaneously in all directions would only invite failures and frustrations. Our prescriptions should be practical and capable of being implemented.

It is clear that a rate of growth that is far beyond domestic savings is not sustainable and could do more harm than good. The method of financing the current account deficit has to be carefully analyzed. If this financing is left to the market, the market would look for only short-term gains. This is inevitable. Central banks should ensure that the constituent banks have their own internal guidelines for exposure to short-term loans and adequate forward planning to match commitments to repayment of these loans. Careful and close monitoring of unhedged positions in the exchange market is imperative. Central banks should ask for publication of these figures by banks at the close of transactions every week.

The Indian rupee has depreciated by about 7–8 percent in the past three to four weeks. This is partly a correction for the previous appreciation and partly a fulfilment of a wish by the markets, as economists, exporters, industrialists, and financial institutions have been calling for a rupee depreciation, only because other currencies have depreciated. I hope this wish fulfillment does not continue.

Inflation in India has been running well below 4 percent over the past six to eight months. Industrial output is still sluggish, but it is expected to grow by about 6 percent to 7 percent. Exports have picked up over the past two or three months, since growing by about 10 percent in dollar terms. Agriculture is showing robust growth. Hopefully, a rate of growth of about 6 percent will be achieved this year, as forecasted by the staff. Reserves are still holding at $24 billion.

I hope members of the Executive Board will agree to the publication of the staff paper for the current discussion.

Mr. Giustiniani made the following statement:

I am grateful to the staff for its clear assessment of the world economic outlook in light of the unfolding financial crisis in Southeast Asia. Since I am in broad agreement with the staff analysis and recommendations, I will make only a few brief comments.

Recent events in Southeast Asia have confirmed that increased integration and efficiency in financial markets means that domestic economic stability, the robustness of financial institutions and markets, and the stability of the international monetary system are strongly linked. In order to avoid the emergence of systemic crises, it becomes increasingly important, first, to ensure sound and orderly economic conditions domestically; second, to enhance the effectiveness of the supervision of financial intermediaries and markets at the national as well as at the international level; and, third, to strengthen economic cooperation at the regional as well as at the international level.

Growing economic and financial integration makes the dilemma confronting countries that are small, open, specialized, and inflation-prone particularly stark.

As to whether to float the currency or move toward monetary unification in Asia, the second choice lacks, at least for the moment, the necessary political support and prerequisites. In the present circumstances, the first avenue seems to be the most viable. Flexible exchange rates provide a two-way bet. They can induce market participants to better assess the risks associated with their investments. Flexible exchange rates usually act as a shock absorber, rather than as a means of exacerbating crisis.

As to the appropriate stance of monetary policy after a currency has been floated, I can join previous speakers in calling for tight monetary policies for two reasons. First, high interest rates are necessary to prevent an overly sharp depreciation of the exchange rate. Second, this is needed to contain the inflationary pressures that can be fostered by the depreciation. Certainly, I agree with other speakers that monetary policy is only one leg of the necessary policy action. The second leg should be provided by the swift implementation of measures to address the main cause of the crisis, which could be related to the budget or to the soundness of the financial system.

One of the causes of the ongoing financial crisis in Southeast Asia may be traced to the differences in the pace of financial deepening and in developing the necessary institutional and legislative framework. However, the presence of distortions in domestic markets, the limited openness to foreign competition, and the interlock between enterprises and financial institutions have been other crucial factors that provided fruitful grounds for the emergence of a crisis.

I agree with the staff recommendations concerning the role of monetary policy, both in the industrial countries and in the countries suffering from crises. It should be noted that the surge in capital inflows to Asian countries fostered a rapid increase in asset prices, either equity or real estate prices. Mutatis mutandis, a strong upward trend in asset prices has also occurred in some industrial economies in the recent period. This experience gives renewed emphasis to the issue of the appropriate role of asset prices in the formulation of monetary policies. The crucial role played by expectations and the tendency of financial markets to form these expectations in an extrapolative way provides further support to calls for a forward-looking stance of monetary policy. In other words, preemptive measures might be needed to break unsustainable trends at an early stage before an abrupt correction may materialize.

With respect to Italy, the staff has pointed out that economic growth may be stronger this year than previously envisaged, in a context of low inflation. I would like to add that the general government deficit this year will be below 3 percent of GDP, and the debt/GDP ratio is expected to fall for the third consecutive year. Similar results are also expected to be achieved next year.

Mr. Esdar made the following statement:

I join those colleagues who have commended the staff for a comprehensive and insightful paper on the background of the current financial crisis and the effects on the world economy and certain countries in particular.

Also the background document on Exit Strategies seems to be a very useful supplement and I cannot help but emphasize that if the conclusions of this paper would have been considered and even more importantly, implemented in some countries some time ago, we would have to deal with significantly less problems now. But I trust that we will have a separate discussion on that paper.

I especially welcome the analysis of the origins of the financial crisis and potential approaches to overcome these difficulties and I have no problems to endorse most of the staff's findings.

In this regard it is especially important to properly weigh the different factors that have contributed to the outbreak of the crisis. However, I was somewhat surprised by the notion that an accommodative monetary policy in some industrial countries had contributed to these problems. I generally agree with the fact that the worldwide soft monetary conditions have provided some over-liquidity and compressed risk premia. On the other hand, monetary policies, if measured by the economic conditions in the respective countries, seemed to be generally appropriate. At least with regard to monetary policy in Germany, I quite frequently noted recommendations from this institution to rather ease monetary policy and if I remember correctly, such recommendations have not always found the full appreciation of my authorities. I wonder whether these new findings would mean a general reorientation of the Fund's approach taken in the past. Further on policy reaction to the crisis in Southeast Asia, I share Mr. O'Loghlin's scepticism with regard to the staff's recommendation to facilitate the adjustment in Asia by easing monetary conditions in industrial countries.

The staff has listed several factors which have contributed to the crisis. These certainly include wrong exchange rate policies, inappropriate monetary policies, a weak financial sector and insufficient banking supervision, but also corporate governance issues. I would like to add one issue which in my view deserves similar emphasis, namely over-reliance on industrial policies, characterized by an environment where subsidized lending, protective measures and tax exemptions were used to pursue sectoral growth objectives, frequently guided by vested interests. Such industrial policies have some parallels to central planning, as they have a certain tendency to neglect or interfere with the incentive structure and allocational function of market signals. Unsustainable industrial and financial structures are often the consequence. This in my view certainly is an issue which has to be given more emphasis in our surveillance exercise, in close contact with the World Bank who has significant responsibility in this area, too.

I also share the findings that many of the problems we are confronted with today are created by an inadequate policy response to over-heating, excessive credit growth and large capital inflows. I also welcome the discussion on potential policy instruments to address those problems and on their respective drawbacks. In general, I agree that each instrument, if taken isolated, has drawbacks as each economic decision involves opportunity costs. However, such a piecemeal approach neglects that the combination of certain instruments might have been a very effective response.

To give an example: Under a continued exchange rate anchor, a monetary tightening might have triggered additional capital inflows and thus contributed to the over-heating. However, a combination of exchange rate flexibility and monetary tightening could have helped to address the problems in many countries at a very early stage. Again, this is discussed in more detail in the Exit Paper, but I think that such messages should be given a more prominent role in the published World Economic Outlook.

There is another issue which deserves a more prominent role and which should be more in the center of this World Economic Outlook, namely the critical discussion of the refusal of many crisis countries, to tighten monetary policy as a first and most effective line of defense in order to prevent or even turn around capital outflows.

In my view, this is one of the most important lessons which could be drawn from our experience in Southeast Asia. There is no chance to reestablish confidence of domestic and international investors and creditors if the country is not prepared to pay the appropriate price for capital.

To avoid any misunderstandings, monetary tightening can by no means provide any panacea. Restructuring of the financial sector, fiscal consolidation, improvements in corporate governance, are of similar critical importance. However, the refusal to use monetary policy effectively due to inappropriate emphasis on financial sector but also growth objectives contributed significantly to the depth and to the extent of the crisis in Southeast Asia. Therefore, I very much welcome the clear message provided by Mr. Mussa at the beginning of today's meeting. I would suggest to reflect these convincing findings prominently in the published version of the World Economic Outlook.

On moral hazard, the position of this chair is well known. Providing huge financial packages will affect private investors and creditors in their lending decisions. Up to now, foreign exchange obligations vis-à-vis foreign banks or investors have been serviced in a timely manner in all problem countries. The tendency to include a certain share of rollover obligations when calculating financial packages seems to confirm those expectations. This chair has suggested to develop ways and means to better integrate private creditors into emergency packages. In general, the G-10 study has suggested different elements to achieve these objectives. While it certainly would be premature for the World Economic Outlook to discuss details, I would suggest to at least elaborate in general terms on the dilemma the Fund is confronted with, namely, on the one hand to establish confidence by providing sufficient financial resources, but on the other hand to limit moral-hazard effects for example by making clear that there might be cases where the financial support of the Fund would not be justified. In this context, I support the call of Mr. Wijnholds to redraft the second sentence of paragraph 2 on page 67 of the World Economic Outlook.

Finally, I have some comments on the forecast for Germany:

First of all, I noted with some surprise, that the staff for 1998 expects growth of only 2.7 percent. While I do not want to go into the fine-tuning business of projections, I would still be interested to get some more information as our own forecasts confirmed by the OECD estimate growth to be around 3 percent.

Secondly, I was also surprised that the Fund discovered in Germany, and I quote "significant margins of cyclical unemployment." The recent Article IV consultation very much emphasized that the overwhelming share of unemployment was caused by structural problems: I remember estimates between 70 and 80 percent. Also here, the staff's comments would be welcome.

Mr. Fernandez made the following statement:

Like other Directors, I welcome the excellent staff paper for the current discussion, which offers a very informative and exhaustive assessment of the Asian crises and their impact on the global economy. On the whole, I share the main messages in the staff paper.

This world economic outlook exercise should address two main types of issues. First, the need to revise the forecasts in the previous *World Economic Outlook* in view of the most recent developments in Asia. This is warranted in view of the magnitude of the revisions for the Asian countries themselves as well as the likely impact of the financial and exchange market crisis on the rest of the world. The assessment that this impact is not necessarily large outside of Asia should be conveyed, together with the uncertainty surrounding the forecast, to the markets. We the staff's view that the risks are clearly on the downside, and we agree that the adjusted figures presented this morning are more realistic.

Second, the interim *World Economic Outlook* should send some general messages to the public about the Fund's analysis of the situation and the associated risks. In particular, strong criticisms have been addressed to the Fund recently, and we must answer them. Why is the Fund unable to stop the crisis, despite large-scale interventions? Are the Fund's policy recommendations relevant? I will limit my intervention to comments on the analysis of the Asian crisis and on the role of the Fund in the present circumstances.

We agree with the staff analysis on the sequencing of the recent turmoil in Asian markets, as well as on the combination of factors that led to the current situation. This analysis points to two driving forces, namely, trends in capital flows to Asia and internal deficiencies, mainly structural, in these economies. The resulting process has been a misallocation of capital into economies that are neither prepared nor resilient enough to cope with a turnaround in confidence.

In this context, we would emphasize two major feature of these crises. First, the strategies developed by highly leveraged domestic entities in order to reduce their exposure to exchange risk have been a major cause of the protracted currency crisis. Second, the lack of sufficient and early commitment to take corrective measures is another factor behind the unfolding of the crisis. This is true particularly with respect to the reluctance of monetary authorities to implement the needed tightening of financial policies in the wake of growing market instability. The staff paper could have stated more clearly that the reluctance to tighten monetary policies played a central role in the current crisis. As the staff suggested, this reluctance has been counterproductive at home and damaging abroad.

More forceful action on the financial sector could also have limited the extent of the decline in confidence. Clearly, these two elements have significantly contributed to make the stabilization process more difficult, despite large-scale support from the international financial community. The staff's findings on the role of hedge funds is also very interesting and it would be useful to convey those findings to others who have shown a great interest in this matter.

Recent events have challenged the ability of the Fund to deal with crises, through both surveillance and its policy recommendations. Recent criticism of Fund surveillance is unfair. Indeed, it is remarkable that the Fund identified prior to the crisis many of the underlying fundamental causes and initiated discussions with the authorities on the potential risks they implied. Nevertheless, we should candidly admit that we do not always refrain from assessing the situation of countries for which crucial data on debt and banking systems are lacking and that we have been shortsighted in a few cases. Contagion effects, in particular, have been largely overlooked.

Furthermore, recent developments may indicate additional areas where closer scrutiny from the Fund will be warranted. Most of these have been addressed by Mr. Wijnholds. This includes, for instance, a reassessment of the risks incurred by countries showing durable current account deficits, even if such deficits are the result of high investment, rather than high consumption. Short-term external debt exposure and the structure of bank foreign currency liabilities, where timely data are available, are also particularly critical. In addition, indicators of asset price bubbles, particularly in stock or real estate markets, would be useful in assessing the risks of unsustainable overinvestment on the domestic side.

Beyond surveillance, the Fund's policy recommendations have been increasingly challenged over recent weeks, most notably as regards the tightening of monetary policy. It is, therefore, all the more important for the

World Economic Outlook to expose explicitly the reasons for such a firm stance in the present context of Southeast Asia.

First, raising interest rates is by far the best way to stop the bleeding in the case of countries facing difficulties in short-term debt rollover. Second, strong action on the fiscal and structural fronts must be taken without delay, but will have an impact only from a longer-run perspective. Third, the regional dimension of the crisis in Asia was also triggered by the reluctance of countries to act decisively on the stabilization front in order to limit currency depreciations and spillover effects. Fourth, although Fund-supported programs require a strict monetary stance, they also provide countries with much-needed liquidity in foreign currency precisely when credit is no longer available. In this context, moral hazard risks should be taken into account and lead us to avoid, as indicated by the staff, the type of blanket guarantees that have been offered in some cases. On the whole, I agree with Mr. Kiekens that the failure of policies pursued to calm financial markets up to now has more to do with the way these policies have been implemented than with their content.

Finally, I can confirm the staff's comments on France, where the most recent data show a strong pickup of internal demand in the third quarter of 1997.

Ms. Lissakers made the following statement:

I will try to be brief. I think we are close to consensus on the causes of the current crisis. I think we recognize that, while our surveillance efforts successfully pinpointed emerging problems in Thailand, we failed to foresee the magnitude and the speed of the contagion, giving insufficient attention to the underlying structural problems that contributed to the spread of the crisis, especially to Korea, and the extraordinary accumulation of short-term debt, which is now the most immediate and pressing financial problem.

The staff report provides a very comprehensive factual description of the proximate causes and the spread of the crisis, but does so in very traditional Fund macroeconomic terms, and perhaps downplays to some extent the underlying structural issues. These include the very high domestic savings and investment rates in these countries, to some extent driven by direct compulsion or indirect measures to restrain private consumption, and the concentration of investment in export-oriented industries developed under hothouse conditions, particularly in Korea, with directed credit and trade protection, as well as the almost exclusive reliance on the banking system to intermediate both national savings and foreign savings to favored sectors, in conjunction with underdeveloped capital markets.

As we know, the model has been very successful in achieving the objectives of rapid growth and rising living standards, but it has also produced distortions and imbalances which are not fully captured by the Fund's traditional focus on budget and external balances. As Mr. Kiekens noted in his statement, until this spring there was little but praise for these economies' strong fundamentals and results, notwithstanding a certain degree of disquiet regarding fragile banking systems and possibly overvalued exchange rates. But these favorable results rested on, and to some extent our surveillance missed, a very substantial volume of private short-term dollar-denominated borrowing abroad, which was only made possible by two interrelated and in retrospect largely unbacked government guarantees, a broad guarantee of exchange rate stability versus the dollar, and a narrower implicit guarantee of such private borrowings. The building excesses, including overcapacity in production and real estate, finally began to reveal themselves this spring and summer, and we have seen them play through.

I think the speed of the contagion is not totally unexplainable, given that there are similarities, or at least perceived similarities, between affected countries, in systems and in accumulated imbalances of overcapacity, overleverage in the private sector, and in the inability to defend the exchange rate because reserves were overcommitted.

Mr. Mussa spoke this morning about the flight to safety, which shows up in both asset prices here and the pressures on the Asian countries. I think that a strong underlying cause that we perhaps should stress more than we do for the flight to safety is the transparency issue—transparency in two regards. One is continued uncertainty about the policy stance in the affected countries. We have debated the wisdom of our policy recommendations, but the fact is that there is still some uncertainty about whether or not the policy prescriptions are actually being followed, and conflicting signals, and I think that feeds the uncertainty and lack of confidence. The other is the uncertainty about the true condition of the private sector. The continued lack of transparency about the condition of individual firms and banks makes it impossible for investors to assess their true condition, and the result is that investors have no choice but, in effect, to make a credit judgment about the country as a whole and to flee from that.

You can ask: why were their investment decisions not affected by this lack of transparency before? It was not, and that is a failure of credit judgment and credit assessment on the part of private investors. But the fact is now that it is very important to improve the transparency of the private sector institution by institution, and to do so fast, so that investors who have the capacity and the desire to come back can make what they feel is a prudent credit assessment of individual institutions.

This goes to the point I made earlier about what I see as the most critical issue facing us in managing this crisis and facing the authorities, and that is a willingness to allocate losses. The failure to do so, as we saw in the 1980s, will lead to a protracted slowdown in these economies, one fully unjustified in terms of the real underlying capacity of these economies. As Mr. Yoshimura said, these are strong economies. If you look at Korea, Korea has a strong industrial base, a high level of education; it has a sophisticated technological capacity. It is really the governance of institutions that has gone wrong, not the underlying real economic capability.

But, if the losses are not allocated, if there is no willingness, and if these countries try to use external financial support, including from this institution, to defer allocating losses, then this crisis will drag on. There has to be an ability to reprice bad assets. That is particularly problematic when you are dealing with commercial banks, and that is a problem with which Japan has grappled for half of this decade at least and has failed to address effectively. I hope the measures that will be announced tomorrow will signal that there will be a concerted and successful effort, finally, to clean out the bad assets and the loans that are the real drag on Japan's economic recovery.

I am afraid that the same tendencies to resist this allocation of losses are manifesting themselves in other Asian countries. One of the manifestations, I think, is this resistance to letting interest rates rise to the level that markets want to put them. I think that the response to this issue, this overriding issue of loss allocation, which is very difficult for every country that has faced them, as we all know, will determine the impact of this crisis on not only those countries' economies but on the world economy.

I think our own projections are pretty much consistent with the Fund's in terms of the outlook, although we project a more substantial narrowing of current account deficits in the Asian countries, i.e. a greater decline in net capital inflows. The imbalances internationally in the current accounts may be somewhat larger than the World Economic Outlook, but in terms of growth and other indicators, I think we are fairly much in line with the Fund's assessment.

Mr. Zamani made the following statement:

I wish to thank the staff for an excellent piece of research, particularly as it is completed under severe time constraints. I have received some feedback from my authorities on suggested editorial changes to the Interim World Economic Outlook paper. As this report may be published, the authorities wish to suggest amendments and updates in order to clarify matters as well as to ensure that whatever is published will not inflame markets further. However, I will communicate directly with the staff on these details.

I also wish to state that I agree with many of the views expressed by Mr. Yoshimura on regional developments. These include the issues of monetary and fiscal policies; the need for a forward looking World Economic Outlook, and a study on contagion. This report, if published, should also send needed assurance to the markets. Hence I agree with Mr. Yoshimura and Mrs. Gonzalez on the need to include the latest developments and policy actions taken by the respective countries.

We broadly agree with the thrust of the staff analysis on the major factors that have contributed to the emergence of the present crisis in Asia. We noted, in particular, the staff's initial findings that speculators and hedge funds seemed not to have played as major a role in this crisis as has been earlier thought. However, this is a very preliminary finding, and we have to wait for the full study on hedge funds to be completed. However, we ought to be wary of the "protests of innocence" and cross-check as far as possible the information received from market participants.

Like the Fund, authorities in the region are quite bewildered at the extant of the contagion, and why the crisis has continued to persist, driving financial and equity markets to weaken to levels that cannot be explained by fundamentals. It is also puzzling that events in Korea in Northeast Asia can still set off severe turbulence in Southeast Asia despite the strong corrective measures that are being undertaken by the authorities in Indonesia, Thailand and Malaysia. Trade and investment linkages may not totally explain the whole picture. One of this is the arguments for the restoration of intra and interregional competitiveness.

The staff is right in stating that the regional and global economic outlook is increasingly difficult to ascertain. First, it is not clear when and for what duration before the affected Asian economies will recover. There have been much talk of Vee-shaped and L-shaped growth recovery scenarios. It may perhaps be more appropriate to consider U-shaped scenarios, as it is a real possibility that given the degree of restructuring and restoration of confidence that needed to be undertaken, a return to prior levels of robust growth will take more time.

Second, we should not only look at the direct impact, but also be aware of the secondary repercussions of the crisis. Industrial economies should not only look more closely at their direct economic linkages with the affected Asian economies. Their major economic partners may have greater exposure to Asia, thus adversely affecting their demand for goods and services from the industrial economies. Also, in his presentation, Mr. Mussa had mentioned of the recent decline in commodity prices. This may have significant adverse impact on the export revenues of major and single commodity producers in developing countries.

A third factor, which may be just as crucial, is uncertainty as to when portfolio investors will regain their confidence in emerging markets. This will determine the direction and magnitude of much needed flows of capital and liquidity into these economies.

We note the earlier discussion this morning on monetary policy adequacy, or the lack of it, in countries facing crisis; and we will relay the substance of the discussion to our authorities.

The Fund on its part should try to better explain to the public and the markets the basis for the programs adopted by countries and supported by the Fund, how they are designed and what they hoped to achieve. Greater understanding of the Fund's role would go some distance in answering recent media discussions on this matter.

Having said this, we must recognize that there may be a need to revisit the adequacy and appropriateness of either the whole or part of Fund advice when the need arises.

Ms. Srejber made the following statement:

Overall, the report is a good and balanced account of the crisis, the policy response, and prospects for the future. I agree with most of the staff's analysis and recommendations. My views on the interim World Economic Outlook are along the lines already expressed by Mr. Wijnholds.

I have some reservations concerning the staff's prescription for an easier monetary policy in Europe and in the United States, in response to a prolongation of the crisis. The report recommends that policymakers in Europe and the United States should be alert to the possibility that the financial crisis in Asia could deepen further, which is sensible advice, but then the staff continues that in such a scenario there could be need for timely monetary easing to arrest an escalating downturn. The shift from local to global focus on monetary policy is a line of thought, the effects of which would need further analysis. I tend at this stage to favor the more traditional view that even while cooperation on macro policies is important, countries should primarily focus on their own goals of monetary policy and keep their own house in order. Good housekeeping at the local level facilitates global order in my opinion. Looking at the present inflation prospects in Europe, with countries at somewhat different stages in the business cycle, and the possible impact of the Asian events on the inflation, it would be necessary with a very negative development in Asia to warrant a general easing of the monetary policy in Europe. At this stage in the cycle, the staff's bad case scenario would, in most countries, more likely result in a need to put interest rates on hold, especially as flight to quality has already lowered bond yields. Of course, a real worst case scenario would change this assessment.

It is also noteworthy that the staff, despite last years' repeated advice to Europe to lower interest rates, blames lax monetary stance in Europe for generating capital flows to emerging markets. The report argues that weak growth in Europe since the beginning of the 1990s has left attractive domestic investment opportunities falling short of available savings, while appropriately leading to accommodative monetary policies and low interest rates. Large private capital flows to emerging markets were driven, to an important degree, by these phenomena, the staff says. Like other speakers, I find the root causes elsewhere and, even if I have some sympathy for the view that abundance of credit contributed to the problem, it seems rather odd to prescribe more credit to cure it.

The proposed approach of globally more lax policies reminds me of the 1970s when the OECD recommended countries to stimulate their economies, in order to "jump over," the effects of the oil crisis. Countries that followed that advice paid the price of these policies for year in terms of higher inflation. It would be interesting to hear the staff's view why it should be different now? Can we rally jump over these crises by Keynesian macro policies?

While growth projections have been revised downward for all regions, the updated forecast for world growth, as compared to the October World

Economic Outlook, is not a cause for much concern. However, growth in Asia is expected to be significantly lower in 1998 than in previous years: 5.7 percent for the region as a whole and 1.7 percent in the ASEAN 4. As Mr. Mussa has already said that the staff may be a little too optimistic with regard to near-term growth prospects in the crisis hit countries, I do not need to say what I planned. On the shape of the turnaround, however, I would like to caution that we are not likely to see a vee-shaped recovery in this market if policy implementation and political uncertainty does not improve. I fully subscribe to Ms. Lissakers' view that there must be a willingness to allocate losses in the financial system and in the corporate sector. Also, in Japan, reforming the financial sector and continuing deregulations in general are the important measures restoring growth. Increased transparency and strengthened accounting rules are other important parts in addressing the problems in the financial sector. I look forward to the coming announcements from the authorities in the area of financial restructuring and hope they will include measures, including the use of public resources, that promptly resolve the banking problems. Such action would also help stabilize financial markets in the rest of Asia.

I appreciate that the question of capital controls was revisited in the report but I think it could have had a stronger focus. While the staff made the case that capital controls were not efficient and even aggravated the problem, and pointed to Korea as a testimony to that assertion, I think some further elaboration on the costs of imposing capital controls during a crisis would have been helpful in light of the ongoing discussion on capital liberalization. In the area of liberalization, the recent agreement of liberalization of financial services within the WTO is welcome. In general, it is of essence that these difficult times are not met with protectionist measures.

On the general issue of pegged exchange rates, and exiting from pegs, it is a well-known fact that countries have not been equally successful in restoring confidence after abandoning their peg. An early return of confidence is based on that the seriousness of the situation is disclosed, that policy weaknesses be addressed with speed and that measures undertaken be transparent. I agree with Mr. Kiekens and Mr. Jonáš that interest rates should be the first line of defense. As we discussed monetary policy this morning, I will not repeat what I said then, just reiterate that it is the full range of policies that matter, both macroeconomic and structural, including, where necessary, financial sector restructuring and a strengthening of financial regulation and supervision. Transparency and disclosure are also important ingredients in confidence building. This message should be included in the World Economic Outlook. That could be enough for today, as we will come back later to the issue of exit strategies. Let me this time just mention that it seems that the advice boils down to "take the medicine before you get sick, as later cure will be difficult and more medicine will be needed."

Mr. Shields made the following statement:

I am generally in agreement with the staff assessment concerning recent developments in Southeast Asia as well as with the comments put forward by previous speakers.

With respect to the outlook itself, I agree with the staff that the central projections probably should be lower than they currently appear in the staff paper. Even with a marginal downward revision, the risks to the projections are clearly on the downside. In the current circumstances, it will be particularly important to stress even more than usual the prevailing uncertainties. For example, it might be helpful to add greater emphasize to the box in the World Economic Outlook on alternative scenarios.

Perhaps, the largest identifiable downward risk with respect to developments in Asia concerns the implementation of the needed policies, which hopefully are now beginning to be put in place. The implementation of corrective policies clearly needs to be more resolute. Otherwise, there will be continued concerns about confidence.

With respect to Mr. Zamani's comments on the shape of the recovery and whether it is likely to be more like a V or a U, the current situation clearly suggests that the recovery will be more like a U, especially at the bottom of the curve, where policies are beginning to take effect. However, a question remains as to whether and, if so, how quickly progress can be made toward the more vertical recovery. Unless there is more determined policy action, it might take some time before Asia can gain the momentum toward recovery that was experienced by Mexico.

Another source of uncertainty is the lack of clarity about likely developments in Japan. As previous speakers, including Ms. Lissakers, have indicated, the Japanese authorities are long overdue in moving forcefully on financial sector restructuring. Fortunately, the Japanese authorities have made significant progress over recent weeks in accepting the inevitable and in putting together the right structures to enable the public sector to take the necessary action. However, it is not clear whether, or when, meaningful action will take place, as the most recent proposals still seem to focus on calls for studies, rather than on the problems. It seems that a great deal of time has already been devoted to studies, what is needed now is action on problem loans, closures, and recapitalization. A meaningful return of confidence can be expected only after those actions are implemented.

I do not have a great deal to add to the staff's analysis of the Asian crisis, except that it would have been helpful to have had more analyses on the dangers of issuing unlimited guarantees to the banking sector, particularly on the foreign exchange liability of the banking sector. Such analyses could have been included in the sections of the staff paper pertaining to the onset of the crisis.

The staff was certainly correct to stress the role played by weaknesses in the financial sector and corporate governance. It could have more strongly emphasized the effect of inappropriate intervention policies by central banks, which was often related to efforts to defend crumbling fixed exchange rate systems. In addition, the implications of the lack of transparency in the financial sector and in the private sector should have been highlighted more generally.

With respect to the question of policy correction, there is no choice in the wake of an exchange rate crisis such as that in Asia but to tighten monetary policies, and to do so with unwavering determination. That is the only way to restore confidence. In such circumstances, any question about the authorities' ability or willingness to put in place necessary policies will further damage confidence and ultimately worsen the pain of adjustment.

It is not as clear with respect to fiscal policy what sort of tightening would be appropriate, particularly in cases where prudent fiscal policies have been in place for some time. Unfortunately, the short-term needs associated with the restoration of financial stability and confidence mean that action on the fiscal front might also be essential, even if the analytical case for fiscal tightening is not immediately convincing. Nevertheless, as in the case of monetary policies, signs of vacillation and uncertainty can prove to be very costly.

With respect to the role of the Fund, I agree with Mr. Esdar's comments on burden sharing. The consideration of orderly debt workout procedures has been delayed too long. There might also be a need to make forthright public announcements concerning the economic outlook for certain regions or countries. On previous occasions, this chair has recommended the use of warning signals, which could be given by the Fund to individual members privately, perhaps in the context of Article IV consultations. There might also be a need to consider delivering such warnings publicly. Such warnings might be good not only for the member country concerned, but also for other members, particularly those within the same region. To draw a medical analogy, the trouble with events such as those in Asia is the risk of contagion. If appropriate remedies are available they should be taken. Clearly, others need the countries affected to be cured or, hopefully, immunized in advance. In that respect, it should be noted that immunization is better than medication, because you can take it before you get sick.

Given the risk of contagion, the Fund needs to carefully examine the situation of other countries that might be vulnerable, particularly other large economies in Asia. In the circumstances, the Fund staff must not be shy about providing policy advice even in countries where the prospects just prior to the crisis seemed favorable. The vulnerability of all economies in Asia has increased and actions that might otherwise not have been necessary may need to be put in place urgently. In that respect, it is probably more important to look at vulnerable countries in the region than it is to focus on possible monetary policy changes in industrial countries, where the notion of putting further action on hold is clearly sensible.

Mr. Palei made the following statement:

I broadly agree with the staff on its analysis of the developments in industrial countries of North America and Europe. I also agree with the importance of the economic developments in Japan for the speed of adjustment in Southeast Asian countries. I am encouraged by the Japanese authorities' policy response outlined by Mr. Yoshimura.

The ongoing economic and financial crises in Southeast Asia clearly demonstrate that financial markets are in the process of adjustment to increased globalization and that the learning process is painful. The principle causes of the crises are deeply rooted and the factors considered in the staff paper as being responsible for the outburst of the crisis seem plausible. The severity of the crises is mainly due to previously overconfident and complacent markets.

I would like to make several comments on the monetary policy in the Asian countries experiencing crises of confidence. Apparently, monetary policy is one of the most controversial issues discussed by this Board. Like Mr. Cippa, I share the pessimistic view about the prospects for growth in the region. I believe that the long period of uninterrupted growth did create very high expectations regarding the future performance of the Asian economies. Financial turmoil forced market agents to reevaluate their estimates of future growth. As a consequence, this and other factors, such as an increased exchange risk premium, may well have shifted the equilibrium level of sustainable capital inflows to a lower level. In turn, the lower level of sustainable capital inflows may warrant a larger adjustment in the exchange rate than has been initially envisaged. If the sustainable level of capital inflows is, indeed, lower, the monetary policy attempting to pull capital flows to pre-crisis levels may be inefficient.

I also note that it would be a mistake to ignore the differences in expectations regarding future growth in Southeast Asia on the eve of the crisis compared with Mexico or Argentina in 1994.

Of course, monetary policy should be sufficiently tight for maintaining macroeconomic control. At the same time, the tightening of the monetary policy beyond this sufficient level will not lead to a reversal in capital flows. I share the view of Mr. Eyzaguirre on the role of the deficiencies in the banking sector in the current crisis. The main factor affecting the prospects for restoration of confidence is the restructuring of the short term external liabilities and of the banking sector in general. This work inevitably takes time. Therefore, at the present time, excessive tightening may be counterproductive. Fears of excessive contraction may drive the exchange rates in the wrong direction.

Like other Directors, I am concerned about the Fund's expectations for the rates of inflation in Southeast Asian countries. When we look at the graphs for Mexican nominal interest rates and follow their ups and downs we should also remember about the price developments in this country. It would be a good idea to have real interest rates on the same graph.

To conclude, my comments are not intended to diminish the role of the prudent fiscal and monetary policy, the role of transparency and consistency in the governments' operations, but rather as a call to continue close monitoring of the relationship between the monetary policy and the developments in market sentiments and the real sector.

Mr. Mafararikwa made the following statement:

The fact that the crisis has hit countries that had been considered successful performers for a long time means that we are not dealing with the typical problem of macroeconomic adjustment. Indeed, the report correctly points out that the medium-term fundamentals of the Asian economies remain sound. However, the rapid shift of funds out of the region has compounded the crisis and will have a significant impact on growth. In this regard, we agree with the rather pessimistic assessment made by the staff this morning regarding the global outlook. In particular, for the rest of the developing world, the sharp increase in the interest rate premium and reduced exports would contribute to further losses in output. Nevertheless, it appears that the global economy is weathering the storm given the strong international cooperation.

As to the origins of the crisis, we would welcome further insights promised in forthcoming papers, in addition to the factors already identified in the staff papers. The problem also is related to the investors' attempt to maximize rates of return on financial investments without paying close attention to the risks associated with those investments. When those risks became evident, it did not take long for the panic button to be pushed.

The task is one of restoring confidence to the region. The report asserts that the main responsibility lies with the countries directly affected. That is true. However, care must be taken not to push adjustment in terms of demand restraint too far, lest growth decelerates even more with adverse spillover effects on the world economy. On the other hand, Asian markets have been important for exports from industrial countries, and sharp contraction in their imports could be destabilizing for the global economy.

On the problem alluded to by Mr. Zamani, that despite monetary tightening the exchange rate continues to slide, we share the view that bold actions on the part of the countries directly concerned must be supported by measures that would stem the outflow of capital. The major lenders should do their part to take pressure off these countries and private actors must know that they have to act in a cooperative spirit, taking comfort from the fact that these economies have strong fundamentals, and that with appropriate restructuring of the financial system—which is where most of the problem lies—there is good reason to believe that these economies will rebound.

Mr. Yao made the following statement:

Since the previous discussion on the world economic outlook exercise, in August 1997 (EBM/97/88 and EBM/97/89), developments in world markets have been greatly influenced by the financial crisis that has continued to spread through Asia. Therefore, I welcome the background paper for the current discussion, which provides an analysis of the root causes of the Asian crisis and its implications for the rest of the world economy.

I agree with previous speakers that the causes of the current crisis are complex. I also agree with the staff that the failure to deal decisively with overheating pressures and weaknesses in the supervisory and regulatory framework of the financial sector has played a major role. It should also be noted that deficiencies in public and corporate governance have led to a sharp deterioration in the quality of bank loan portfolios. All these factors and the apparent lack of political will to address them have exacerbated the crisis. Nevertheless, questions remain about the extent to which the regional crisis was attributable to contagion effects and the reasons that it happened so abruptly.

At the previous discussion on developments, prospects, and key policy issues in international capital markets (EBM/97/79, 7/30/97), the staff recognized that some signs of a financial crisis were clearly apparent in emerging markets. At that time, the staff indicated, with respect to the slow growth in emerging markets in Asia, that the underlying liquidity in the corporate sector, the lack of preparedness among some financial institutions, and the worsening of asset quality were causes for concern. It also said that, unless growth and export performance improved in 1997, the banks in some Asian countries could face significant challenges with respect to their profitability and possibly their solvency. Therefore, it seems that the crisis was not brought about by contagion, but by major weaknesses in the banking system.

As Mr. Esdar pointed out, the industrial rationalization loan was a major factor. The staff paper notes that 56 percent of the loans provided under the industrial rationalization loan were nonperforming, which created significant risks for the banking system in Korea. At this juncture, the main question is whether a lasting cure for the crisis can be found in the foreseeable future. I agree with the staff that considerable uncertainties remain about the depth and duration of the crisis. I also agree with Ms. Lissakers that the solution will need to address the question of allocating losses.

It is to be hoped the current policy response, which involves the Fund, will be sufficient to restore market confidence. In this context, the countries directly affected have already taken various measures to prepare the ground for a much-needed rebound in economic activity. These steps, including restrictive monetary policies, are appropriate to stabilize exchange markets. The authorities should also be prepared to restructure the financial sector and to give priority to measures aimed at improving governance, thus enhancing transparency and accountability. It would be advisable for the major industrial countries to hold off on tightening monetary policy at least at the present stage. The Fund has played a positive role in this crisis, in particular by providing appropriate assistance in a timely manner.

Nevertheless, one of the consequences of the Asian crisis has been a sharp slowdown in private capital flows to emerging markets and other regions. It is also expected that a lengthening of the current crisis is likely to affect commodity prices. As the staff noted, commodities represent the bulk of African exports. In the circumstances, I wonder whether the African economies will be adversely affected by a further deepening of the crisis.

The staff was correct to point out that the ongoing crisis tempts some policy makers to put in place various capital controls. The question of doing so is particularly important at the present stage, when the Fund is recommending the liberalization of capital account transactions. It could be argued that capital controls may be necessary and useful on a short-term basis. However, over the longer-run, they may become harmful to the countries that use them. Experience in some of the countries in my constituency illustrates this point.

Finally, I would welcome the publication of the staff paper, as amended by Directors. It is to be hoped that the interim World Economic Outlook will help policy makers and investors in making important choices and, thereby, further the effort to restore confidence in the financial markets.

The staff representative from the Research Department noted that the staff projections on inflation were based on the assumption of only a partial pass-through of exchange rate depreciations, because import prices tended to rise less than the mechanical effect of depreciation would suggest and because propensities to import would likely decline with the increase in relative prices. The staff's estimates on the pass-through of exchange rate depreciation were somewhat smaller than standard estimates of pass-through effects might suggest, because they tried to take into account the assumed tightening of macroeconomic policies and the sharp deceleration in domestic demand in the countries affected by the crisis. Of course, projections on inflation were problematic at the present stage, as exchange rates were continuing to decline in many countries and it was difficult to judge the level at which they might stabilize.

As Mr. Wijnholds had pointed out, the problems of Russia and Ukraine had been exacerbated by the holdings of their debt in emerging market countries, the staff representative said. The staff would try to take that point into account in revising the World Economic Outlook.

A few Directors had expressed disappointment about the lack of an analysis on contagion effects in the staff paper for the current discussion, the staff representative recalled. That subject would likely be examined in detail in the spring 1998 World Economic Outlook, in the context of discussions on the causes of financial crises. It also would likely be the subject of other staff papers on the Asian crisis.

The Deputy Director of the Research Department commented, with respect to the projections contained in the staff paper, that there were clearly downside risks, which could lead to a significantly weaker outcome. In that respect, Directors were correct to note the need for some downward revision in the forecast for world growth. However, it would be difficult at the present stage to project how such a downward revision should be distributed across countries. For example, one of the most significant uncertainties was related to the large current account deficits projected worldwide. Although current account deficits would likely be addressed through greater adjustment on the part of emerging market countries, that was not yet certain. It was also possible that growth would be weaker than previously forecasted in the industrial countries and, as a result, there might be greater scope for larger financing flows to the emerging market countries. The staff projections reflected the consensus view held among the staff as of December 1997. However, there were considerable differences of view about how the crisis was likely to evolve over the period ahead and the way in which certain groups of countries might be affected. While it clearly would not be appropriate to put forward projections that might be considered unrealistic, it would also be inappropriate to go too far beyond the consensus, perhaps unnecessarily adding to some of the gloomy forecasts characterizing the possible effects of the crisis. In that respect, it was important to bear in mind that forecasting was an iterative process. The staff would continue to revise its forecasts over the period ahead in preparation for the spring 1998 World Economic Outlook. Meanwhile, it would be important to carefully explain the risks associated with the crisis in Asia and the margin of uncertainty, which was larger than usual, in the staff projections.

The staff paper was certainly not meant to suggest that monetary policy in the industrial countries could be blamed for the buildup of difficulties in the emerging market economies in Asia, the Deputy Director said. Rather, it attempted to explain how the international environment had facilitated large capital inflows in Asia. The large net capital inflows to Asia that occurred in the first half of the 1990s would not have been possible had it not been for the large margins of slack in Japan and in Europe at that time. While those margins clearly justified the easy stance of monetary policy in Europe and Japan, it also helped to explain the large capital inflows to countries in Asia. The significant cyclical element in those capital flows suggested that, once cyclical conditions in Japan and Europe returned to normal, capital flows to emerging market economies would likely subside to levels below those experienced in the first half of the 1990s.

It was difficult to see how the large U.S. deficit had contributed directly to the buildup of current account deficits in the emerging market economies, the Deputy Director commented. Nevertheless, there did appear to be some linkage, at least to the extent that the large capital inflows to the emerging market countries were sterilized, thus contributing to the large buildup of international reserves, which, in turn, were invested largely in U.S. short-term securities. In that respect, there had been a sort of "round-tripping" of liquidity through the emerging market countries to the United States. However, the role of the U.S. deficit was probably more important in contributing to the unsustainability of the large external deficits in the emerging market countries. In the last half of 1996 and the first half of 1997, when Europe was recovering and Japan was emerging from a long recession, it became difficult for financial markets to continue to provide large net inflows to both the United States and the emerging market countries.

The Economic Counsellor and Director of the Research Department said that the only controversial issue, with respect to the industrial countries other than Japan, was how monetary policy in North America and Europe might be influenced by developments in the emerging markets. The argument was not that U.S. or European monetary policy should be run for the purpose of stabilizing the Asian economies, but that developments in Asia and other emerging market countries would have an impact on the United States and on Europe and, thus, need to be taken into account in formulating policies. Growth in the United States was likely to be slower than otherwise would have been the case, owing to the events in Asia; hence, there was a less pressing need to tighten monetary policy. Also, inflationary pressures would be negatively affected by developments in Asia and in world commodity markets, again decreasing the need for a firming of monetary conditions. Indeed, if the Asian crisis proved to be substantially more severe than currently envisaged, prospects for growth in the United States and in the world economy could be considerably weaker, in which case there could be good arguments for easing of U.S. monetary policy. Moreover, in the midst of the current financial market turbulence, it would not be helpful for the United States to increase the federal funds rate at the present stage, especially as it was not clear that such an increase could be justified on grounds of developments in the domestic economy. However, given the strength of growth in the U.S. economy, it might not be reasonable to presume that the Federal Reserve Board would be able to hold off an increase in interest rates for another 12 months. In that respect, it should be borne in mind that monetary policy would need to be governed by the performance of the U.S. economy, particularly given the possibility of overheating. However, that did not appear to be an eminent threat. Similar considerations would apply to monetary policy in Europe as in the United States.

Japan had been a main focus of Directors' comments, the Economic Counsellor noted. While a few Directors had emphasized the importance of staying the course on fiscal consolidation, a few others had suggested that it might be appropriate to opt for some measures to apply fiscal stimulus. The staff's view on that question had been evolving over recent weeks, as the growth prospects for Japan had become weaker. The most recent available data showed that the growth prospects were weaker at the present stage than they had been in the previous month. That development clearly strengthened the case against further fiscal tightening, and it might be prudent for the authorities to begin to look for opportunities to spur the economy forward. However, that was not to suggest a return to the large fiscal stimulus packages employed in the early 1990s.

The Japanese authorities were preparing to officially announce a package of fiscal measures aimed at helping to strengthen the financial sector, the Economic Counsellor said. Indeed, the main elements of that package had already been reported in the press. The World Economic Outlook would take into account that package of measures, which clearly represented a step in the right direction. However, it would not be possible at the present stage to suggest that an end to Japan's financial sector problems was in sight. Given prevailing time constraints, it would probably not be possible to examine the fiscal package in detail in the current World Economic Outlook.

It was the staff's understanding that, under the proposed fiscal package, ¥10 trillion in interest-free bonds would be made available to the Deposit Insurance Corporation to protect depositors and boost shareholder equity in financial institutions, the Economic Counsellor stated. The Deposit Insurance Corporation would also buy preferred stock and subordinated debt issued by financial institutions to help them increase shareholder equity, basically using contributions from private banks and borrowing from the Bank of Japan. That proposal suggested that, in the event that the Deposit Insurance Corporation faced subsequent shortages, it would be able to call on the government to provide more cash. The government would then redeem the bonds for the amount needed using the proceeds from the sale of its equity in Nippon Telegraph and Telephone, and perhaps other government holdings.

The staff had some concerns about the proposed fiscal package, the Economic Counsellor commented. First, the actual size of the bad loan problem in Japan was not yet certain. Official government estimates, based on a reasonably precise set of definitions, suggested a total size of about ¥27 trillion, with the expectation that unrecoverable losses would be on the order of ¥8–10 trillion. The IBCA, a private analysis and rating agency that used somewhat broader definitions, estimated that problem loans at about ¥ 80 trillion, with unrecoverable losses amounting to as much as ¥50 trillion. The staff did not endorse the IBCA estimate and it did not intend to report on it in the World Economic Outlook. However, it was important to note the magnitude of the discrepancy between the official government estimates and some of the estimates currently being discussed in the private sector and in the financial sector. Moreover, that larger estimate would not be overlooked as the proposed package was evaluated in the private sector financial markets.

At the present stage, it did not seem to be entirely clear how the public funds would be used when they became available, the Economic Counsellor continued. Presumably, they would be used to compensate depositors in institutions that had been closed. However, it was not absolutely clear what the attitude would be toward the closure of further institutions. In addition, there was widespread suspicion that a number of institutions remain significantly insolvent. In that case, it would be prudent and efficient in terms of the functioning of the financial sector to close those institutions and pay off their depositors, and let the solvent institutions take over the responsibility for financial operations in Japan. In the event that insolvent institutions were not closed, the proposed package would probably not be sufficient to convince market participants that Japan's long-standing financial sector problems were being solved.

It clearly would be premature to try to draw any formal conclusions about the effectiveness of the proposed package at the present stage, the Economic Counsellor considered. The staff would hope to make a full assessment of the fiscal package for the next world economic outlook exercise. Nevertheless, there was some concern that the financial market reaction to the proposed package might not be quite as positive and as reassuring as hoped for, given the critical situation in Asia and the prevailing concerns about the Japanese economy and its financial system.

As to the analysis and policy prescriptions concerning the crisis in Southeast and East Asia, many Directors had commented on the limited analysis on the role of monetary policy in dealing with crisis situations in the staff paper for the current discussion, the Economic Counsellor noted. The staff would try to upgrade the discussion of that important issue in the interim World Economic Outlook. The Board also might wish to take up that issue in more detail in a separate discussion. The spring 1998 World Economic Outlook would take up the issues related to monetary policy in greater detail than the staff paper currently under consideration, but perhaps not in the detail that would be appropriate for a separate Board discussion on that topic.

The staff would tend to agree with Mr. Kiekens and Mr. Jonáš that determining the appropriate stance of monetary policy in a crisis situation, or in the period preceding a potential financial market crisis, required a difficult balancing act, the Economic Counsellor commented. Nevertheless, in such situations, it was essential for monetary policies to be pursued in a determined and consistent manner. The oscillation in policies in Asian countries, which had undermined confidence, had played a significant role in the problems those countries encountered.

Experience also showed that early efforts to pursue an accommodative monetary policy stance tended to be counterproductive, the Economic Counsellor continued. Such policies could actually make matters worse by contributing to an erosion of confidence and exchange rate depreciation. That was especially true for countries with large volumes of private sector foreign debt, because it could encourage panic, which, in turn, exacerbated the fall in exchange rates. In such circumstances, the effort to recover from a crisis often demanded even tighter monetary policies than would have been required had firmer monetary policies been pursued consistently from the outset. Experience in Mexico showed that the monetary authorities, which had not raised interest rates high enough at the first signs of difficulty, were forced to implement much tighter monetary policies later, after the exchange rate fell sharply.

Foreign indebtedness was a very important factor in such circumstances, the Economic Counsellor went on. A comparison of the Asian experience with that of the United Kingdom in the early 1990s illustrated that point. In 1992–93, when the Bank of England began to ease monetary policy—after maintaining a very tight policy stance, which had disinflated the economy and produced a severe recession—in advance of the rest of Europe, the pound sterling depreciated. That fairly sudden depreciation complicated matters for Ireland and a few other countries that had been trying to keep their currencies within the ERM, but the monetary loosening, and consequent depreciation, was clearly appropriate to the needs of the U.K. economy. There was no rush on the part of businesses and financial institutions in the United Kingdom to pay off their foreign exchange debts; thus, there was no undue pressure to make the exchange rate decline precipitously. The volume of the United Kingdom's foreign currency–denominated debt had not been sufficiently large to give way to such pressures. However, in the Asian economies, as in the case of Mexico, there had been a run on foreign exchange, owing to the large volume of debt denominated in foreign currencies.

In the Asian situation, contagion was also a matter for concern, the Economic Counsellor added. During the initial stages of the financial sector turmoil, the staff had underestimated the spread and the magnitude of contagion effects within the region. The over depreciation of the Thai baht clearly brought pressure on the currencies of Indonesia and Malaysia. The Hong Kong dollar was brought under pressure not only owing to the excessive depreciation of the Thai baht, but also owing the depreciation of the New Taiwan dollar. As Mr. Yoshimura had correctly pointed out, a tight monetary policy pursued simultaneously by a number of countries could have significant effects domestically as well as on trading partners. However, in the case of Asia, those effects would have been much milder had it not been for the large volumes of short-term, foreign currency–denominated debt held by the countries concerned.

With respect to the questions concerning a possible default by Korea, it should be noted that, at least at the outset, the large volume of short-term Korean debt outstanding was not sovereign debt, but primarily short-term private sector debt, the Economic Counsellor stated. In late August, the government had announced that it was going to guarantee all financial sector short-term debt. That announcement was irresponsible, first, because Korea did not have adequate resources to back such a guarantee and, second, because some of Korea's reserves were nonusable; they had been lent to Japanese financial institutions that had onlent them abroad for various purposes. That announcement transformed what would have been a difficult problem, in terms of managing private sector restructurings and possibly liquidations, into an extremely dangerous situation, involving the possibility of a sovereign default. The experience of Korea illustrated the fundamental principle that governments should not extend guarantees that would have the effect of converting private sector difficulties into potential sovereign defaults. It was to be hoped that, in the context of the summing up on the next Article IV consultation with Korea, the Board would discuss the way in which Korea had managed its foreign exchange reserve position and the provision of such guarantees. The approach taken by Korea entailed the types of measures that could seriously complicate the smooth functioning of the international monetary system. While much of the ill effects of that approach were being felt in Korea itself, they were also spilling over to other countries.

In the current circumstances, it would be extremely difficult to manage an involuntary restructuring of those debts, and it would have uncertain consequences, the Economic Counsellor said. If the process of restructuring had been started sooner, before the extension of government guarantees, and if the authorities had enforced the principle of separation of sovereign debt and private debt, it might have been possible to avoid a crisis of the magnitude currently under way. Moreover, the creditors of insolvent firms would not have been able to withdraw their capital, because many of the firms would have gone bankrupt, and there would have been no incentive for investors to withdraw capital from solvent firms. In that respect, the staff would agree with Ms. Lissakers that the tendency for countries to avoid the allocation of losses was a source of many difficulties. That was true not only in Korea, but also in other countries, including the industrial countries.

Against that background, the issue of managing moral hazard and market discipline was critical, the Economic Counsellor considered. At the present stage, there was no broadly accepted way to deal with the prospect of sovereign default. The only way to avoid it was for countries to carefully monitor and manage debt, especially short-term, foreign currency–denominated debt.

Also with respect to the issue of moral hazard, it should be noted that a lot of people who invested in emerging markets had suffered significant losses, the Economic Counsellor said. Equity investments and foreign direct investments had dropped precipitously in value. Some of that capital had not been invested prudently, and investors had realized the risks involved in the form of losses. However, that fact likely would not prevent a repetition of such crises in the future, although having been burned, investors might be shy about engaging in high-risk investments for a while.

Experience showed that the issue of moral hazard existed even in the absence of government guarantees or international bailouts, the Economic Counsellor stated. There was a widespread presumption that foreign loans, particularly to large financial institutions, came with implicit sovereign guarantees. In that respect, it should also be noted that there was no way to impose losses on creditors holding fixed-interest claims in the absence of a default. Although there probably should be more defaults among a number of countries' private sector enterprises and financial institutions, important questions arose with respect to the possible default of major financial institutions of systemic importance, especially given the adverse economic implications such a default could have not only for the country concerned, but also for others. It was for that reason that the Fund staff had been emphasizing the need to strengthen financial sector supervision and regulation in a way that would prevent dominant financial institutions from getting into unsustainable situations. There was also a widely held belief that financial institutions became insolvent, owing primarily to hard economic times. In such circumstances, insolvency was not seen as being attributable either to the management of the institutions affected or to problems of supervision or regulation. In some cases, that belief might be correct. Economic calamities could occur. However, too many financial institutions in too many countries were barely solvent even when their economies were performing well; thus, when even moderate economic problem arose, they could be thrust into serious problems of solvency.

Mr. Yao asked the staff to comment on the extent to which recent problems among financial institutions in Asian countries could be attributed to contagion.

The Economic Counsellor responded that many insolvent financial institutions survived for years, particularly if they received direct or indirect government transfers that enabled them to attract low-cost deposits. For example, the savings and loan industry in the United States, which initially ran into serious difficulties in 1980, had managed to stay a float for an entire decade. That problem had been allowed to fester and grow. Nevertheless, as inventive as U.S. savings and loan regulators were, they had not been able to keep that industry afloat indefinitely. In some respects, that experience was similar to the case of Korea. The problems in the structure of the corporate sector and the financial system itself in Korea had been longstanding. While those problems had been exacerbated by the weakening by the Korean economy over the past couple of years, the financial system and enterprises would likely have been able to stay afloat—given the beginning of the recovery in Korea—had it not been for the crisis in the region. Essentially, the contagion effects of the regional crisis hit Korea at a time when the corporate and financial sectors were particularly vulnerable.

There was a general tendency, not only in Asia, but virtually everywhere, to avoid considering whether all of the short-term foreign currency debts of a country could be repaid as they matured if no one was prepared to embark on roll overs, the Economic Counsellor stated. Indeed, whenever that question was asked, the answer was almost always negative. Korea had found itself in a position where, in the light of events elsewhere in the region, market participants began asking that unfortunate question. The crisis itself actually began in Thailand, but the contagion effects quickly spread elsewhere, owing to the emergence of that question.

The judgment of the staff for some time had been that, although very large flows of capital to emerging market countries were appropriate in economic terms, the magnitude of those flows had risen in 1996–97 to levels that brought into question their sustainability, especially as the world economic environment moved into a phase of higher interest rates in the industrial countries, the Economic Counsellor recalled. On several previous occasions, the staff had expressed concerns that the international environment would change in a way that might place undue pressures on emerging market economies. In the event, those pressures emerged with respect to Thailand and other countries in Southeast Asia. However, even if that crisis had not occurred, it was not clear that the problem related to capital flows would have been avoided altogether. Indeed, repeated episodes of financial and exchange market turmoil had occurred in the past. It was for that reason that a more permanent change in the policy environment was needed to place countries and the world economic system in a better position to avoid such episodes and to better contain and manage them when they did emerge.

Mr. Ono noted, with respect to the staff's comments on the comparison between the size of the recently announced fiscal package, of ¥10 trillion, in Japan and private estimates of the bad loan problem, amounting to up to ¥80 trillion, that the purpose of the package was to strengthen the financial system, in particular the ability of the Deposit Insurance Corporation to protect depositors. If the government had prepared a fiscal package equal in size to the bad loan problem, problems of moral hazard would clearly arise.

The basic policy stance of the Japanese authorities was to make every effort to consolidate the trend toward economic recovery and to stabilize the financial sector, while maintaining the framework for structural fiscal reform, Mr. Ono stated. The initiative on using the proceeds from the sale of government equity in Nippon Telegraph and Telephone was an additional measure that could be used if necessary. It was to be hoped that market participants would react more favorably than the staff to the governments' recent proposals.

Mr. Shields asked whether the purpose of the ¥10 trillion was to cover depositors. He also wondered whether the bond issue underwritten by the proceeds from the sale of government equity in Nippon Telegraph and Telephone was fully liquid or whether its liquidity would depend on the conditions under which equity shares in Nippon Telegraph and Telephone could be sold.

Mr. Ono responded that the ultimate purpose of strengthening the Deposit Insurance Corporation was to enable it to serve as the final defense to protect depositors. Of course, the first defense of the reserve account of DIC was financed by the Bank of Japan. The Deposit Insurance Corporation was also to help support the recapitalization of financial institutions, including through the purchase of preferred stock and/or subordinate bonds.

Mr. Shields commented that, in the light of problems encountered elsewhere with the issuance of broad government guarantees, it was to be hoped that the Japanese government would be very specific in identifying who would be protected by the Deposit Insurance Corporation.

The Acting Chairman made the following summing up:

> Directors welcomed the opportunity provided by the staff's interim assessment to discuss the implications for the global economic outlook of the financial turmoil in Asia. With events in Asia still unfolding, Directors emphasized the unusually large uncertainties that necessarily attach to the present projections, and regarded them as being of a preliminary nature.
>
> Directors generally concurred with the staff's analysis of the origins and evolution of the financial crises in several Asian economies. A number of factors had contributed to the buildup of recent difficulties. Those included some positive features of the economic performance in recent decades of the countries affected, which had helped to attract large-scale capital inflows during the 1990s. External factors had also played a role: in particular, low asset yields in industrial countries had encouraged those capital inflows, while the appreciation of the U.S. dollar and slower export market growth in the affected economies had adversely affected trade and growth performance in 1996–97, contributing to the disruptive shifts in market sentiment.
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> Directors agreed, however, that policy weaknesses in the countries affected had been most important. Most Directors noted that, in most of the crisis cases—Korea being the main exception—inflexible exchange rate arrangements had to a significant extent made it more difficult for monetary

policy to play its role in containing overheating pressures. Directors generally placed most emphasis, however, on the role played by structural weaknesses, especially in financial sectors. Inadequate regulation and supervision of financial institutions, combined with weaknesses in the institutions themselves, had fostered imprudent lending, which in some cases had been boosted by unsustainable levels of short-term foreign borrowing. Moreover, market discipline on the allocation of resources and on the volume of capital investment had been to varying degrees impeded by excessive government intervention, thus further distorting not only the deployment of the financial inflows from abroad, but also the effective intermediation of domestic financial resources. Directors also noted that significant delays in confronting the seriousness of the problems and adopting the requisite monetary policy and structural reform measures had compounded the economic difficulties experienced by the affected countries and the attendant contagion effects. Directors also stressed that the recent experience amply demonstrated the importance of accurate and timely provision of information. The need for timely and complete data on financial and banking indicators, short-term external debt, and reserve-related liabilities was particularly emphasized.

Most Directors agreed that the staff's baseline scenario represented a cautiously optimistic assessment, and one that was subject to a wide margin of uncertainty. In particular, the baseline projections assume that, with appropriate and timely adjustment and reform efforts in the countries affected, together with the support of the international community, sentiment toward the emerging market countries in Asia will begin to turn around in the year ahead, although private external financing to the emerging markets in all likelihood will not return to the high levels seen in 1996. The drop in capital flows now being experienced will generate significant declines in the current account deficits of the countries affected, through weaker domestic demand and activity as well as the large exchange rate depreciations that have taken place. These adjustments, in turn, will feed through negatively to activity in trading partners. Growth in most Asian emerging market economies is set to slow significantly in the period ahead. Capital inflows and rates of expansion in emerging market countries of other regions are also likely to slow, but by less than in Asia. For the world as a whole, output growth seems likely to moderate to about 3½ percent, a downward adjustment of 0.8 percent compared with the projection in the October 1997 World Economic Outlook.

Directors expressed concern, however, that there appeared to be significant downside risks to the central projection for global growth. In particular, the projected pattern of current account positions may not be sustainable, and it seems likely that the emerging market countries may have to undertake more adjustment in response to reduced capital inflows than allowed for in the baseline. This points to what Directors agreed is among the most important sources of uncertainty—the scale, distribution, and duration of the decline in capital flows. In this context, Directors considered that the alternative scenarios presented by the staff provide useful illustrations of the implications of larger financing shortfalls.

Directors emphasized that the outcome will depend on policies, and generally concurred with the staff's analysis of the policy actions needed to contain the crisis. They agreed that the main responsibility for taking appropriate action to limit the economic damage lies with the countries directly affected, and that hesitation in the implementation of the needed adjustment and reform measures can only worsen the crisis and exacerbate overshooting in financial markets and contagion to other countries. In this context, a number of speakers questioned the adequacy of the commitments of the authorities in some of the affected countries and argued that this had added to market turbulence. All Directors agreed that bold actions to address key policy weaknesses are indispensable for confidence to be restored and for the ground to be prepared for a solid rebound from the current difficulties. They particularly stressed four areas for action.

First, a priority in a crisis situation is to reassure domestic and foreign investors that macroeconomic stability will be restored. However, some speakers questioned the need for significant tightenings of fiscal policy, since the Asian economies in crisis generally do not suffer from fiscal imbalances. Directors agreed that the required degree and composition of fiscal adjustment needs to strike a balance between several objectives, including the need to contribute sufficiently to the process of current account adjustment and to meet the costs of the restructuring of financial systems while avoiding excessive compression of domestic demand.

Second, Directors emphasized that monetary policies need to be kept sufficiently firm to resist excessive depreciation, its inflationary consequences, and spillovers on partner countries' currencies. A monetary tightening up front is essential to restore market confidence quickly, while the requisite banking and other structural reform measures are getting under way. Several Directors observed that monetary policy alone cannot restore confidence and stability and that the extent and duration of the monetary tightening needed to stabilize markets would depend on the signals country authorities give markets about their willingness and resolve to accomplish the necessary reforms and the speed with which such efforts are pursued. They agreed that as confidence is restored, monetary conditions should be allowed to ease to help support activity, but emphasized the danger of premature easing. Directors particularly stressed the importance of providing adequate incentives for financial institutions and corporations to roll over short-term loans in cases in which the repayment of such loans risks exacerbating downward pressures on the exchange rate.

Third, Directors agreed on the key priority of addressing weaknesses in the financial sector that had been exposed and exacerbated by the recent difficulties. They emphasized that bold and comprehensive measures are essential to dispel uncertainties in the financial sector. While it is necessary to ensure adequate protection for small deposit holders, insolvent institutions need to be closed to facilitate an early restoration of confidence, and weak but viable institutions need to be restructured and recapitalized in ways that are fully transparent and do not inappropriately shield creditors and equity holders from losses or exacerbate problems of moral hazard.

Fourth, Directors stressed the need to strengthen public and corporate governance, to enhance transparency and accountability, and to provide on an accurate and timely basis data, especially on financial and banking sector indicators. These issues appropriately had received a high degree of attention in the policy programs supported by Fund arrangements in Thailand, Indonesia, and Korea.

Directors noted that the prolonged crisis in Southeast Asia and East Asia had raised the prospect that other emerging market countries, which had already experienced some spillovers, could witness an intensification of financial market pressures. While reform efforts have been strengthened considerably among the developing countries in recent years, Directors cautioned that a number of countries remain vulnerable to reversals of market sentiment, especially in view of the general reappraisal of emerging market risks. Directors considered that the policy requirements in those countries are similar to those that apply to the countries that have already been affected.

In addition, several speakers thought that some countries would need to consider whether greater exchange rate flexibility might help to reduce the risk and cost of speculative attacks on their currencies. Directors agreed that, whichever exchange arrangement countries choose to follow, the arrangement can provide protection against currency market turmoil only if it is fully supported by strong macroeconomic policies and robust financial systems.

Directors agreed that the imposition of capital controls during a crisis might well worsen confidence and add to turbulence in financial markets. At the same time, a number of speakers argued that the emerging market countries should not liberalize their capital accounts prematurely and that,, especially in light of the extension of the Fund's mandate to the capital account, there was a need to better understand the preconditions for an orderly liberalization, among which undoubtedly was a strengthening of the financial system. Several other speakers suggested that the weaknesses in financial sectors that had been exposed by the recent crises in Asia could be attributed in part to the failure to liberalize the financial markets in those countries, which had impeded resource allocation. Directors generally agreed on the critical importance of prudential regulations to limit banking system exposure to currency market turmoil.

Directors also discussed the role of the international community in helping to contain the crisis. They noted the substantial financial support that is being provided by the Fund, in collaboration with other international agencies and bilateral sources. In this context, several Directors expressed concern about the possible moral hazard implications of the current crisis resolution mechanisms, and stressed that it was important to the maximum extent to ensure that Fund financing did not serve to bail out private creditors. They noted that the burden of financial support should not be assumed by the Fund, other international financial institutions, and the official sector alone, but that private sector creditors should play a part as well.

A number of speakers emphasized that, while financial market conditions remain unsettled, authorities in the major industrial countries should be cautious in considering any further tightening of monetary policy. Most Directors felt it would be appropriate to put further tightening on hold for the moment, particularly given the prospect in most cases of continuing subdued inflation. Some Directors felt, however, that domestic monetary policy should be aimed solely at dealing with the condition of the domestic economy.

Several speakers felt that the situation in Japan was of particular concern for the country itself, for the rest of Asia, and indeed for the global economic outlook. The importance of Japan in the global economic and financial system, as well as its role in Asia, made it critical that uncertainties about the health of its financial system be resolved. To this end, Directors called for resolute action to address the strains in the Japanese financial sector, including the closure of insolvent institutions and the well-targeted use of public funds to assist in the restructuring that is urgently needed. In this regard, Directors welcomed the planned introduction of measures to facilitate financial sector restructuring, and expressed the hope that those measures would be adequate to the needs of the occasion.

Most Directors also called for modest expansionary fiscal measures to help avoid any further withdrawal of fiscal stimulus until recovery is reestablished. Directors also emphasized the need to speed up the process of deregulation to enhance domestic investment opportunities and, thereby, reduce Japan's persistently large external surplus.

Despite the seriousness of the issues confronting many of the Asian economies, Directors took comfort from the fact that growth in North America and Europe has been well sustained recently and is likely to provide support for the global economy during the period ahead. This suggests that the economies now experiencing difficulty will be able to benefit from a relatively favorable external environment. Speakers stressed that, given the medium-term growth potential of the countries at the center of the crisis, they could expect to regain market confidence once their structural weaknesses, especially in the financial sector, had been addressed.

DECISIONS TAKEN SINCE PREVIOUS BOARD MEETING

The following decisions were adopted by the Executive Board without meeting in the period between EBM/97/121 (12/15/97) and EBM/97/122 (12/16/97).

2. GENERAL ARRANGEMENTS TO BORROW—BORROWING AGREEMENT BETWEEN SAUDI ARABIA AND FUND—RENEWAL

Pursuant to Article VII, Section 1 of the Articles of Agreement, the Managing Director is authorized to send to the Minister of Finance of Saudi Arabia a letter as set forth in the attachment to EBS/97/232, proposing a further renewal, for a period of five years from December 26, 1998, of the 1983 borrowing agreement with Saudi Arabia in association with the General Arrangements to Borrow. When a reply is received from the Minister accepting the proposal, the Managing Director's letter and the reply shall constitute an agreement on the further renewal of the 1983 borrowing agreement between Saudi Arabia and the Fund, which shall enter into force on December 26, 1998.

Decision No. 11626-(97/122), adopted
December 15, 1997

3. APPROVAL OF MINUTES

The minutes of Executive Board Meeting 97/71 are approved.

APPROVAL: June 8, 1998

REINHARD H. MUNZBERG
Secretary